

Energy Transfer Partners, L.P.  
Form 424B3  
June 24, 2005  
**Table of Contents**

**Index to Financial Statements**

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**PROSPECTUS SUPPLEMENT**

**(To Prospectus dated January 12, 2004)**

**1,640,000 Common Units**

**Representing Limited Partner Interests**

We are offering 1,640,000 common units representing limited partner interests of Energy Transfer Partners, L.P. to 10 purchasers in a privately negotiated transaction pursuant to this prospectus supplement at a price of \$31.95 per common unit.

**Investing in the common units involves risk. See Risk Factors beginning on page S-4 of this prospectus supplement and on page 6 of the accompanying prospectus.**

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

June 17, 2005

**Table of Contents**

**Index to Financial Statements**

*This document is in two parts. The first part is this prospectus supplement, which describes the terms of this offering of common units. The second part is the accompanying prospectus, which gives more general information, some of which may not apply to the common units. If the information in this prospectus supplement varies from the information in the accompanying prospectus, you should rely on the information contained in this prospectus supplement.*

*You should only rely on the information contained or incorporated by reference in this prospectus supplement or the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in this prospectus supplement or the accompanying prospectus is accurate as of any date other than the date on the front of those documents or that any information we have incorporated by reference is accurate as of any date other than the date of the document incorporated by reference. Our business, financial condition, results of operations and prospects may have changed since these dates.*

**TABLE OF CONTENTS**

**Prospectus Supplement**

|  |      |
|--|------|
| <u>Summary</u>                                       | S-1  |
| <u>The Offering</u>                                  | S-3  |
| <u>Risk Factors</u>                                  | S-4  |
| <u>Use of Proceeds</u>                               | S-8  |
| <u>Price Range of Common Units and Distributions</u> | S-9  |
| <u>Tax Considerations</u>                            | S-10 |
| <u>Plan of Distribution</u>                          | S-11 |
| <u>Experts</u>                                       | S-12 |
| <u>Where You Can Find More Information</u>           | S-13 |
| <u>Glossary</u>                                      | S-14 |

**Prospectus**

|  |     |
|--|-----|
| <u>About this Prospectus</u>   | 3   |
| <u>Who We Are</u>  | 3   |
| <u>The Subsidiary Guarantors</u>   | 5   |
| <u>Risk Factors</u>  | 6   |
| <u>Forward-Looking Statements</u>  | 28  |
| <u>Use of Proceeds</u>   | 29  |
| <u>Ratio of Earnings to Fixed Charges</u>  | 29  |
| <u>Energy Transfer Transaction</u>   | 32  |
| <u>Energy Transfer Selected Historical Financial Data</u>                                    | 35  |
| <u>Heritage Propane Partners Selected Historical Financial and Operating Data</u>            | 36  |
| <u>Heritage Propane Partners Pro Forma Financial Data</u>                                    | 40  |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 44  |
| <u>Business</u>  | 74  |
| <u>Management</u>  | 102 |
| <u>Related Party Transactions</u>  | 105 |
| <u>Description of Units</u>  | 107 |
| <u>Cash Distribution Policy</u>  | 119 |
| <u>Description of the Debt Securities</u>  | 126 |
| <u>Selling Unitholders</u>   | 138 |
| <u>Material Tax Considerations</u>   | 140 |
| <u>Investment in Us by Employee Benefit Plans</u>  | 157 |

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|  |     |
|--|-----|
| <u>Plan of Distribution</u>                | 158 |
| <u>Legal Matters</u>                       | 159 |
| <u>Experts</u>                             | 159 |
| <u>Where You Can Find More Information</u> | 161 |

**Table of Contents**

**Index to Financial Statements**

**SUMMARY**

*This summary highlights information contained elsewhere in this prospectus supplement. You should read the entire prospectus supplement, the accompanying prospectus, the documents incorporated by reference and the other documents to which we refer for a more complete understanding of this offering. You should read Risk Factors beginning on page S-4 of this prospectus supplement and page 6 of the accompanying prospectus for more information about important risks that you should consider before buying common units in this offering. The information presented in this prospectus supplement assumes that the underwriters do not exercise their over-allotment option. Throughout this prospectus supplement and the accompanying prospectus, we refer to ourselves, Energy Transfer Partners, L.P., and our predecessor, Heritage Propane Partners, L.P., as we, us, our or Energy Transfer Partners.*

**Energy Transfer Partners, L.P.**

We are a rapidly-growing master limited partnership engaged in the natural gas midstream, transportation and storage business, with operations in Texas and Louisiana, and in the retail propane marketing business, with operations in 33 states.

Our midstream, transportation and storage business owns and/or operates approximately 11,700 miles of natural gas gathering and transportation pipelines, three natural gas processing plants, two of which are currently connected to our gathering systems, 14 natural gas treating facilities and three natural gas storage facilities. Our midstream segment focuses on the transportation, gathering, compression, treating, processing and marketing of natural gas, and its operations are currently concentrated in the Austin Chalk trend of southeast Texas, the Permian Basin of west Texas, the Barnett Shale in north Texas and the Bossier Sands in east Texas. Our midstream segment also includes the recently acquired Houston Pipeline System which is comprised of approximately 4,200 miles of intrastate natural gas pipeline, the 65 Bcf of working gas underground Bammel storage reservoir and related transportation assets. The Houston Pipeline System has access to multiple sources of historically significant natural gas supply reserves from south Texas, the Gulf Coast, east Texas and the western Gulf of Mexico and is directly connected to major gas distribution, electric and industrial load centers in Houston, Corpus Christi, Texas City, Baytown, Beaumont and Port Arthur. Our transportation and storage segment focuses on the transportation of natural gas through the Oasis pipeline, our Bossier pipeline, our natural gas pipeline and storage assets that we refer to as the ET Fuel System and certain transportation assets of the recently acquired Houston Pipeline System. The Oasis pipeline is a 583-mile natural gas pipeline that directly connects the Waha Hub, a major natural gas trading center located in the Permian Basin of west Texas, to the Katy Hub, a major natural gas trading center near Houston, Texas. The Bossier pipeline, which became commercially operational in June 2004, connects natural gas supplies in east Texas to our Katy pipeline. The ET Fuel System, which serves some of the most active drilling areas in the United States, is comprised of approximately 2,000 miles of intrastate natural gas pipeline and related natural gas storage facilities located in Texas. With approximately 460 receipt and/or delivery points, including interconnects with pipelines providing direct access to power plants and interconnects with other intrastate and interstate pipelines, the ET Fuel System is strategically located near high-growth production areas and major markets such as the Waha Hub, the Katy Hub and the Carthage Hub, three major natural gas trading centers located in Texas. The Houston Pipeline System consists of six main transportation pipelines and three market area loops and has direct access to multiple market hubs at Katy, the Houston Ship Channel, Ague Dulce and through its operation of the Bammel storage facility.

In April, 2005, we announced that we had completed the sale of our Oklahoma gathering, treating and processing assets, which we refer to as our Elk City System, to Atlas Pipeline Partners, L.P.

We are the fourth largest retail propane marketer in the United States, serving more than 650,000 customers from 311 customer service locations. Our propane operations extend from coast to coast, with concentrations in the western, upper midwestern, northeastern and

southeastern regions of the United States.

S-1

**Table of Contents**

**Index to Financial Statements**

We were originally formed in conjunction with our initial public offering as Heritage Propane Partners, L.P. in June 1996. In January 2004, we combined the propane operations of Heritage Propane Partners with the natural gas midstream and transportation operations of La Grange Acquisition conducted under the name Energy Transfer Company. We refer to this combination, along with the incurrence of debt and the issuance of our equity securities in connection with that combination, as the Energy Transfer Transactions. In March 2004, we changed our name to Energy Transfer Partners, L.P.

Our executive offices are located at 2838 Woodside Street, Dallas, Texas 75204. Our telephone number is (214) 981-0700. We maintain a website at <http://www.energytransfer.com> that provides information about our business and operations. Information contained on this website, however, is not incorporated into or otherwise a part of this prospectus.

**Table of Contents**

**Index to Financial Statements**

**THE OFFERING**

|  |   |
|--|---|
| Common units offered                                     | 1,640,000 common units.   |
| Common units outstanding immediately after this offering | 103,884,572 common units.   |
| Other units outstanding immediately after this offering  | 1,000,000 class C units<br>and 8,853,832 class E units.   |
| Use of proceeds  | We will receive net proceeds of approximately \$52.1 million from this offering. We plan to use the net cash proceeds from this offering for general partnership purposes.                                |
| Risk Factors   | Please read <b>Risk Factors</b> beginning on page S-4 of this prospectus supplement and on page 6 of the accompanying prospectus for a discussion of risks relating to an investment in our common units. |
| New York Stock Exchange symbol                           | ETP.  |

**Table of Contents**

**Index to Financial Statements**

**RISK FACTORS**

*An investment in our common units involves a high degree of risk. You should carefully consider the following risk factors included below and under the caption "Risk Factors" beginning on page 3 of the accompanying prospectus, together with all of the other information included in, or incorporated by reference into, this prospectus supplement in evaluating an investment in our common units. If any of these risks were to occur, our business, financial condition or results of operations could be adversely affected. In that case, the trading price of our common units could decline and you could lose all or part of your investment.*

**We may be unable to successfully integrate the operations of the ET Fuel System and the Houston Pipeline System with our operations and to realize all of the anticipated benefits of the acquisition of the ET Fuel System and the Houston Pipeline System.**

Integration of the ET Fuel System and the Houston Pipeline System with our business and operations will be a complex, time consuming and costly process. Failure to successfully integrate the ET Fuel System and the Houston Pipeline System with our business and operations in a timely manner may have a material adverse effect on our business, financial condition and results of operations. The difficulties of combining the companies include, among other things:

operating a significantly larger combined company and integrating additional midstream operations to our existing operations;

the necessity of coordinating geographically disparate organizations, systems and facilities;

integrating personnel with diverse business backgrounds and organizational cultures; and

consolidating corporate and administrative functions.

In addition, we may not realize all of the anticipated benefits from our acquisition of the ET Fuel System and the Houston Pipeline System due to a number of potential factors including the impact of competition, fluctuations in markets, higher costs and difficulties in integrating operations.

We will also be exposed to risks that are commonly associated with transactions similar to this acquisition, such as unanticipated liabilities and costs, some of which may be material, and diversion of management's attention. As a result, the anticipated benefits of the acquisition may not be fully realized, if at all.

**We encounter competition from other midstream, transportation and storage companies and propane companies.**



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We experience competition in all of our markets. Our principal areas of competition include obtaining natural gas supplies for the Southeast Texas System and natural gas transportation customers for the Oasis Pipeline, the Bossier Pipeline and the ET Fuel System. Our competitors include major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas. The Oasis Pipeline competes directly with two other major intrastate pipelines that link the Waha Hub and the Houston area, one of which is owned by Duke Energy Field Services, LLC and the other one of which is owned by El Paso Corporation and American Electric Power Service Corporation. The Southeast Texas System competes with natural gas gathering and processing systems owned by Duke Energy Field Services, LLC. The Bossier Pipeline competes with other natural gas transportation pipelines that serve the Bossier Sands area in east Texas and the Barnett Shale area of the Fort Worth Basin in north Texas. The ET Fuel System competes with a number of other natural gas pipelines, including interstate and intrastate pipelines that link the Waha Hub and the Dallas/Ft. Worth area and other pipelines that serve the east central Texas and south Texas markets. Pipelines that we compete with in these areas include those owned by Atmos Energy Corporation, Enterprise Products Partners, L.P. and Enbridge, Inc. Many of our competitors have greater financial resources and access to larger natural gas supplies than we do.

The acquisition of the Houston Pipeline System, which will increase the number of interstate pipelines and natural gas markets to which we have access, will also expand our principal areas of competition to areas such as southeast Texas and the Texas Gulf Coast. As a result of our expanded market presence and diversification, we will face additional competitors, such as major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas, that have greater financial resources and access to larger natural gas supplies than we do.

Our propane business competes with a number of large national and regional propane companies, and several thousand small independent propane companies. Because of the relatively low barriers to entry into the retail propane market, there is potential for small independent propane retailers, as well as other companies that may not currently be engaged in retail propane distribution, to compete with our retail outlets. As a result, we are always subject to the risk of additional competition in the future. Generally, warmer-than-normal weather further intensifies competition. Most of our propane retail branch locations compete with several other marketers or distributors in their service areas. The principal factors influencing competition with other retail propane marketers are:

price,

reliability and quality of service,

responsiveness to customer needs,

safety concerns,

long-standing customer relationships,

the inconvenience of switching tanks and suppliers, and

the lack of growth in the industry.

**We are exposed to the credit risk of our customers, and an increase in the nonpayment and nonperformance by our customers could reduce our ability to make distributions to our unitholders.**

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Risks of nonpayment and nonperformance by our customers are a major concern in our business. Participants in the energy industry have been subjected to heightened scrutiny from the financial markets in light of past collapses and failures of other energy companies. We are subject to risks of loss resulting from nonpayment or nonperformance by our customers. Any increase in the nonpayment and nonperformance by our customers could reduce our ability to make distributions to our unitholders.

S-4

**Table of Contents**

**Index to Financial Statements**

**Our increased debt level may limit our future financial and operating flexibility.**

As of February 28, 2005, we had approximately \$1.8 billion of consolidated debt outstanding, which represents 67% of our total book capitalization as of that date. As a result of the acquisition of the ET Fuel System and the Houston Pipeline System and the related financings, our financial leverage is higher. Our level of indebtedness affects our operations in several ways, including, among other things:

a significant portion of our cash flow from operations will be dedicated to the payment of principal and interest on outstanding debt and will not be available for other purposes, including payment of distributions;

covenants contained in our existing debt arrangements require us to meet financial tests that may adversely affect our flexibility in planning for and reacting to changes in our business;

our ability to obtain additional financing for working capital, capital expenditures, acquisitions and general partnership purposes may be limited;

we may be at a competitive disadvantage relative to similar companies that have less debt; and

we may be more vulnerable to adverse economic and industry conditions as a result of our significant debt level.

**The ET Fuel System and the Houston Pipeline System are subject to operational, regulatory and environmental risks.**

The operations of the ET Fuel System and the Houston Pipeline System are similar in many ways to the operations conducted by our existing transportation assets, and as a result, are subject to similar operational risks, regulatory requirements, environmental liabilities and pipeline right-of-way issues as potentially exist for our current transportation assets as described in the accompanying prospectus. Please read "Risk Factors - Risks Related to our Midstream and Transportation Business" and "Business - Energy Transfer Company Regulation" in the accompanying prospectus.

In addition, the ET Fuel System and the Houston Pipeline System are subject to the jurisdiction of the TRRC. Generally, the TRRC has jurisdiction over all underground storage of natural gas in Texas, unless the facility is part of an interstate gas pipeline facility. Because the ET Fuel System and the Houston Pipeline System natural gas storage facilities are only connected to intrastate gas pipelines, they fall within the TRRC's jurisdiction. Under the TRRC's regulations, a natural gas storage facility must have a commission-issued permit to operate. Our purchase of the assets of the ET Fuel System from TXU Fuel Company required us to apply for transfers of the permits as operators of the storage facilities acquired from TXU Fuel Company. We have made applications for the transfer of these permits and are awaiting TRRC approval. Some changes to a permit, such as facility expansions and increases in the maximum operating pressure, must be approved through an amendment process before the TRRC. In addition, the TRRC must approve transfers of the permits. The TRRC's regulations also require all natural gas storage facilities to be operated to prevent waste, the uncontrolled escape of gas, pollution and danger to life or property. Accordingly, the TRRC requires natural gas storage facilities to implement certain safety, monitoring, reporting and record-keeping measures. Violations of the terms and provisions of a TRRC permit or a TRRC order or regulation can result in the modification, cancellation or suspension of an operating permit and/or civil penalties, injunctive relief, or both.

**The ET Fuel System and the Houston Pipeline System are comprised of assets such as storage facilities for which we do not have operating experience.**

The assets of the ET Fuel System and the Houston Pipeline System included storage facilities, which are a type of asset that we have limited experience operating. Operation of these assets will subject us to different governmental regulations and may result in increased costs. The success of our business strategy related to the operation of the ET

S-5

## **Table of Contents**

### **Index to Financial Statements**

Fuel System and the Houston Pipeline System is dependent upon our ability to capitalize on significant operating synergies to further enhance the value of the assets. If we are unable to operate these assets in accordance with our business strategy, it could have a material adverse effect on our results of operations.

#### **Our storage business depends on neighboring pipelines to transport natural gas.**

To obtain natural gas, our storage business depends on the pipelines to which they have access. Many of these pipelines are owned by parties not affiliated with us. Any interruption of service on those pipelines or adverse change in their terms and conditions of service could have a material adverse effect on our ability, and the ability of our customers, to transport natural gas to and from our facilities and a corresponding material adverse effect on our storage revenues. In addition, the rates charged by those interconnected pipelines for transportation to and from our facilities affect the utilization and value of our storage services. Significant changes in the rates charged by those pipelines or the rates charged by other pipelines with which the interconnected pipelines compete could also have a material adverse effect on our storage revenues.

#### **We may not be able to fully execute our growth strategy if we encounter illiquid capital markets or increased competition for qualified assets.**

Our strategy contemplates growth through the development and acquisition of a wide range of midstream, transportation, storage, propane and other energy infrastructure assets while maintaining a strong balance sheet. This strategy includes constructing and acquiring additional assets and businesses to enhance our ability to compete effectively and diversify our asset portfolio, thereby providing more stable cash flow. We regularly consider and enter into discussions regarding, and are currently contemplating, the acquisition of additional assets and businesses, stand alone development projects or other transactions that we believe will present opportunities to realize synergies and increase our cash flow.

We may require substantial new capital to finance the future development and acquisition of assets and businesses. Limitations on our access to capital will impair our ability to execute this strategy. Expensive capital will limit our ability to develop or acquire accretive assets. We may not be able to raise the necessary funds on satisfactory terms, if at all.

Consistent with our acquisition strategy, we are continuously engaged in discussions with potential sellers regarding the possible acquisition of additional assets or businesses. Such acquisition efforts may involve our participation in processes that involve a number of potential buyers, commonly referred to as "auction" processes, as well as situations where we believe we are the only party or one of a very limited number of potential buyers in negotiations with the potential seller. We can give you no assurance that our current or future acquisition efforts will be successful or that any such acquisition will be completed on terms considered favorable to us.

In addition, we are experiencing increased competition for the assets we purchase or contemplate purchasing. Increased competition for a limited pool of assets could result in us losing to other bidders more often or acquiring assets at higher prices. Either occurrence would limit our ability to fully execute our growth strategy. Our inability to execute our growth strategy may materially adversely impact the market price of our securities.

#### **Our pipeline integrity program may impose significant costs and liabilities on us.**

In December 2003, the U.S. Department of Transportation issued a final rule requiring pipeline operators to develop integrity management programs to comprehensively evaluate their pipelines, and take measures to protect pipeline segments located in what the rule refers to as high consequence areas. The final rule resulted from the enactment of the Pipeline Safety Improvement Act of 2002. The final rule was effective as of January 14, 2004. Based on the results of our current pipeline integrity testing programs, we estimate that compliance with this final rule for our existing transportation assets will result in capital costs of \$4.5 million during 2005 to 2010, as well as operating and maintenance costs of \$1.8 million during 2005 to 2010. We are continuing to assess the impact of this final rule on the ET Fuel System and the Houston Pipeline System and cannot predict any estimated compliance costs for those assets at this time. Integrity testing and assessment of all of these assets will continue, and the potential exists that results of such testing and assessment could cause us to incur even greater capital and operating expenditures for repairs or upgrades deemed necessary to ensure the continued safe and reliable operation of our pipelines.

S-6

**Table of Contents**

**Index to Financial Statements**

**If we do not make acquisitions on economically acceptable terms, any future growth will be limited.**

Our ability to grow and to increase distributions to unitholders is dependent principally on our ability to make acquisitions that are accretive to our distributable cash flow per unit. Our acquisition strategy is based, in part, on our expectation of ongoing divestitures of pipeline assets by large industry participants. A material decrease in such divestitures would limit our opportunities for future acquisitions and could adversely affect our operations and cash flows available for distribution to our unitholders.

In addition, we may be unable to make such accretive acquisitions for any of the following reasons, among others:

because we are unable to identify attractive acquisition candidates or negotiate acceptable purchase contracts with them;

because we are unable to raise financing for such acquisitions on economically acceptable terms; or

because we are outbid by competitors, some of which are substantially larger than us and have greater financial resources and lower costs of capital than we do.

Furthermore, even if we consummate acquisitions that we believe will be accretive, they may in fact result in no increase or even a decrease in distributable cash flow per unit. Any acquisition involves potential risks, including risks that we may:

fail to realize anticipated benefits, such as new customer relationships, cost-savings or cash flow enhancements;

decrease our liquidity by using a significant portion of our available cash or borrowing capacity to finance acquisitions;

significantly increase our interest expense or financial leverage if we incur additional debt to finance acquisitions;

encounter difficulties operating in new geographic areas or new lines of business;

incur or assume unanticipated liabilities, losses or costs associated with the business or assets acquired for which we are not indemnified or for which the indemnity is inadequate;

be unable to hire, train or retrain qualified personnel to manage and operate our growing business and assets;

less effectively manage our historical assets, due to the diversion of management's attention from other business concerns;

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incur other significant charges, such as impairment of goodwill or other intangible assets, asset devaluation or restructuring charges.

If we consummate future acquisitions, our capitalization and results of operations may change significantly. As we determine the application of our funds and other resources, you will not have an opportunity to evaluate the economics, financial and other relevant information that we will consider.

On January 26, 2005, we consummated the acquisition of a controlling interest in the Houston Pipeline System for approximately \$825.0 million, subject to working capital adjustments. In addition, the payment for the inventory of working gas stored in the Bammel storage facility was financed through a short-term borrowing from a related party. We may be exposed to some or all of the risks described above in connection with this acquisition.

S-7



**Table of Contents**

**Index to Financial Statements**

**USE OF PROCEEDS**

We will receive net proceeds of approximately \$52.1 million from this offering. We plan to use the net cash proceeds from this offering for general partnership purposes.

S-8

**Table of Contents****Index to Financial Statements****PRICE RANGE OF COMMON UNITS AND DISTRIBUTIONS**

The common units are listed and traded on the New York Stock Exchange under the symbol ETP. The following table shows the high and low sales prices for the common units on the New York Stock Exchange Composite Transactions Tape and the cash distribution paid per common unit for the quarterly periods ending on the dates indicated.

**Common Unit Price Range  
and Cash Distributions (a)**

| <b>Price Range</b>  | <b>High</b> | <b>Low</b> | <b>Cash<br/>Distributions(b)</b> |
|---------------------|-------------|------------|----------------------------------|
| <b>Fiscal 2002</b>  |             |            |                                  |
| November 30, 2001   | \$ 14.495   | \$ 12.325  | \$ 0.31875                       |
| February 28, 2002   | 15.275      | 12.755     | 0.31875                          |
| May 31, 2002        | 14.50       | 13.25      | 0.31875                          |
| August 31, 2002     | 13.80       | 11.25      | 0.31875                          |
| <b>Fiscal 2003</b>  |             |            |                                  |
| November 30, 2002   | \$ 14.125   | \$ 12.25   | \$ 0.31875                       |
| February 28, 2003   | 14.785      | 13.525     | 0.31875                          |
| May 31, 2003        | 14.95       | 13.88      | 0.31875                          |
| August 31, 2003     | 16.27       | 14.80      | 0.3250                           |
| <b>Fiscal 2004</b>  |             |            |                                  |
| November 30, 2003   | \$ 19.35    | \$ 15.51   | \$ 0.3250                        |
| February 29, 2004   | 21.33       | 18.78      | 0.3500                           |
| May 31, 2004        | 20.125      | 17.25      | 0.3750                           |
| August 31, 2004     | 21.69       | 18.935     | 0.4125                           |
| <b>Fiscal 2005</b>  |             |            |                                  |
| November 30, 2004   | \$ 27.00    | \$ 21.59   | \$ 0.4375                        |
| February 28, 2005   | 32.55       | 25.925     | 0.4625                           |
| May 31, 2005        | 32.69       | 29.75      | 0.4875                           |
| August 31, 2005 (c) | 33.99       | 32.00      |                                  |

- (a) All common unit and cash distributions have been adjusted to reflect the 2-for-1 unit split that was effected in March 2005.  
 (b) Distributions are shown in the quarter with respect to which they were declared.  
 (c) Through June 17, 2005.

The last reported sales price of common units on the NYSE on June 17, 2005 was \$33.99 per common unit. As of June 17, 2005, there were approximately 55,000 individual common unitholders.

**Table of Contents**

**Index to Financial Statements**

**TAX CONSIDERATIONS**

The tax consequences to you of an investment in our common units will depend in part on your own tax circumstances. For a discussion of the principal federal income tax considerations associated with our operations and the purchase, ownership and disposition of our common units, see

Material Tax Considerations in the accompanying prospectus. You may wish to consult with your own tax advisor about the federal, state, local and foreign tax consequences peculiar to your circumstances.

Ownership of common units by tax-exempt entities, regulated investment companies and foreign investors raises issues unique to such persons. Recent legislation treats net income derived from the ownership of certain publicly traded partnerships (including us) as qualifying income to a regulated investment company. However, this legislation is only effective for taxable years beginning after October 22, 2004, the date of enactment. For taxable years beginning on or before the date of enactment, very little of our income will be qualifying income to a regulated investment company. Please read Material Tax Consequences Tax-Exempt Organizations and Other Investors in the accompanying prospectus.

Because of widespread state budget deficits, several states are evaluating ways to subject partnerships to entity-level taxation through the implementation of state income, franchise or other forms of taxation. If any state were to impose a tax upon us as an entity, our cash available for distribution would be reduced.

**Table of Contents**

**Index to Financial Statements**

**PLAN OF DISTRIBUTION**

We are selling the common units offered under this prospectus supplement directly to five investors in a privately negotiated transaction in which no party is acting as an underwriter. Subject to the terms of a purchase agreement dated June 17, 2005, the investors have agreed to purchase and we have agreed to sell to the investors 1,640,000 common units at a price of \$31.95 per common unit. The price per common unit was determined through negotiations with the investors based upon the market price for the common units.

We expect to deliver the common units through our transfer agent on June 20, 2005.

S-11

**Table of Contents**

**Index to Financial Statements**

**EXPERTS**

The consolidated financial statements of Energy Transfer Partners, L.P. as of August 31, 2004, and for the year ended August 31, 2004; the consolidated financial statements of Heritage Propane Partners, L.P., as of August 31, 2003, and for the period ended January 19, 2004 and for the years ended August 31, 2003 and 2002; the consolidated balance sheet of U.S. Propane, L.P. as of August 31, 2004; and the consolidated balance sheet of U.S. Propane, L.L.C. as of August 31, 2004, all incorporated by reference in the prospectus and elsewhere in the registration statement of which the prospectus is a part from our Annual Report on Form 10-K for the year ended August 31, 2004, have been audited by Grant Thornton LLP, independent registered public accounting firm, as indicated in their reports with respect thereto, and are incorporated by reference in the prospectus in reliance upon the authority of said firm as experts in giving such reports. The audit report covering the consolidated financial statements of Heritage Propane Partners, L.P. refers to a change in accounting for stock-based compensation.

The consolidated financial statements of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002 and for the periods ended September 30, 2002 and December 31, 2001; and the consolidated financial statements of Oasis Pipe Line Company as of December 27, 2002 and the period then ended; and the combined financial statements of Energy Transfer Company as of August 31, 2003 and for the eleven months then ended, incorporated by reference in this prospectus have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their reports thereon, and are incorporated by reference herein in reliance upon such reports given on the authority of such firm as experts in accounting and auditing. The audit report covering the consolidated financial statements of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002, and for the periods ended September 30, 2002 and December 31, 2001 refers to a change in accounting for goodwill and other intangible assets.

The financial statements of TXU Fuel Company as of December 31, 2003 and 2002 and for the years then ended included in this prospectus have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report which report expresses an unqualified opinion and includes an explanatory paragraph referring to the adoption of Statement of Financial Accounting Standards No. 143 which is included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The financial statements of HPL Consolidation LP as of December 31, 2004 and 2003, and for each of the three years in the period ended December 31, 2004, included in this prospectus have been audited by Deloitte & Touche LLP, independent registered public accounting firm, as stated in their report, which is included herein, and have been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

**Table of Contents**

**Index to Financial Statements**

**WHERE YOU CAN FIND MORE INFORMATION**

We have filed a registration statement with the SEC under the Securities Act of 1933 that registers the securities offered by this prospectus. The registration statement, including the attached exhibits, contains additional relevant information about us. The rules and regulations of the SEC allow us to omit some information included in the registration statement from this prospectus.

In addition, we file annual, quarterly and other reports and other information with the SEC. You may read and copy any document we file at the SEC's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-732-0330 for further information on the operation of the SEC's public reference room. Our SEC filings are available on the SEC's web site at <http://www.sec.gov>. We also make available free of charge on our website, at <http://www.energytransfer.com>, all materials that we file electronically with the SEC, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Section 16 reports and amendments to these reports as soon as reasonably practicable after such materials are electronically filed with, or furnished to, the SEC. Additionally, you can obtain information about us through the New York Stock Exchange, 20 Broad Street, New York, New York 10005, on which our common units are listed.

The SEC allows us to incorporate by reference the information we have filed with the SEC. This means that we can disclose important information to you without actually including the specific information in this prospectus by referring you to other documents filed separately with the SEC. These other documents contain important information about us, our financial condition and results of operations. The information incorporated by reference is an important part of this prospectus. Information that we file later with the SEC will automatically update and may replace information in this prospectus and information previously filed with the SEC.

We incorporate by reference in this prospectus the documents listed below:

our annual report on Form 10-K for the year ended August 31, 2004;

our definitive proxy statement filed by us under Section 14(a) of the Securities Exchange Act of 1934 on May 18, 2004;

our quarterly reports on Form 10-Q for the quarters ended November 30, 2004 and February 28, 2005;

our current reports on Form 8-K filed June 14, 2004 (as amended on June 23, 2004), September 23, 2004, October 25, 2004, November 1, 2004 (as amended on November 2, 2004), November 3, 2004, January 3, 2005, January 12, 2005 (with respect to Item 8.01 only), January 19, 2005, January 31, 2005 (with respect to Item 8.01 only), February 1, 2005 (as amended on March 17, 2005), March 11, 2005, March 16, 2005, and April 12, 2005;

the description of our common units in our registration statement on Form 8-A (File No. 1-11727) filed pursuant to the Securities Exchange Act of 1934 on May 16, 1996; and

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all documents filed by us under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 between the date of this prospectus and the termination of the registration statement.

You may obtain any of the documents incorporated by reference in this prospectus from the SEC through the SEC's website at the address provided above. You also may request a copy of any document incorporated by reference in this prospectus (including exhibits to those documents specifically incorporated by reference in this document), at no cost, by visiting our internet website at [www.energytransfer.com](http://www.energytransfer.com), or by writing or calling us at the following address:

Energy Transfer Partners, L.P.

8801 South Yale Avenue, Suite 310

Tulsa, Oklahoma 74137

Attention: Robert A. Burk

Telephone: (918) 492-7272

S-13

**Table of Contents**

**Index to Financial Statements**

**GLOSSARY**

The following is a description of the meanings of some of the oil and natural gas industry terms used in this prospectus supplement.

***Bbl.*** One stock tank barrel, or 42 U.S. gallons liquid volume, used herein in reference to crude oil or other liquid hydrocarbons.

***Bcf.*** One billion cubic feet of gas.

***Bcf/d.*** One billion cubic feet of gas per day.

***Btu.*** British thermal unit, which is heat required to raise the temperature of a one-pound mass of water from 58.5 to 59.5 degrees Fahrenheit.

***Mcf/d.*** One thousand cubic feet of gas per day.

***MMBtu.*** One million Btus.

***MMcf/d.*** Million cubic feet of natural gas per day.

***Reservoir.*** A porous and permeable underground formation containing a natural accumulation of producible natural gas and/or oil that is confined by impermeable rock or water barriers and is separate from other reservoirs.



**Table of Contents**

**Index to Financial Statements**

**PROSPECTUS**

**\$800,000,000**

**Energy Transfer Partners, L.P.**

**Common Units**

**Debt Securities**

---

**Heritage Operating, L.P.**

**Debt Securities**

---

**1,988,846**

**Common Units**

**Offered By Selling Unitholders**

---

The following securities may be offered under this prospectus:

Common units representing limited partner interests in Energy Transfer Partners, L.P.;

Debt securities of Energy Transfer Partners, L.P.; and

Debt securities of Heritage Operating, L.P., in an aggregate initial offering price of \$800,000,000; and

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Up to 1,988,846 common units offered by selling unitholders.

The aggregate initial offering price of the securities that we offer by this prospectus will not exceed \$800,000,000. We will offer the securities in amounts, at prices and on terms to be determined by market conditions at the time of our offerings. This prospectus describes only the general terms of these securities and the general manner in which we will offer the securities. The specific terms of any securities we offer will be included in a supplement to this prospectus. The prospectus supplement will describe the specific manner in which we will offer the securities and also may add, update or change information contained in this prospectus. The common units are traded on the New York Stock Exchange under the symbol ETP.

You should read this prospectus and the prospectus supplement carefully before you invest in any of our securities. This prospectus may not be used to consummate sales of our securities unless it is accompanied by a prospectus supplement.

**Investing in our securities involves risk. You should carefully consider the risk factors described under Risk Factors beginning on page 3 of this prospectus before you make any investment in our securities.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined whether this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

**The date of this prospectus is January 12, 2004.**

- 1 -

**Table of Contents****Index to Financial Statements****TABLE OF CONTENTS**

|  | <b>Page</b> |
|--|-------------|
| <u>About this Prospectus</u>   | 3           |
| <u>Who We Are</u>  | 3           |
| <u>The Subsidiary Guarantors</u>   | 5           |
| <u>Risk Factors</u>  | 6           |
| <u>Forward-Looking Statements</u>  | 28          |
| <u>Use of Proceeds</u>   | 29          |
| <u>Ratio of Earnings to Fixed Charges</u>  | 29          |
| <u>Energy Transfer Transaction</u>   | 32          |
| <u>Energy Transfer Selected Historical Financial Data</u>                                    | 35          |
| <u>Heritage Propane Partners Selected Historical Financial and Operating Data</u>            | 36          |
| <u>Heritage Propane Partners Pro Forma Financial Data</u>                                    | 40          |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 44          |
| <u>Business</u>  | 74          |
| <u>Management</u>  | 102         |
| <u>Related Party Transactions</u>  | 105         |
| <u>Description of Units</u>  | 107         |
| <u>Cash Distribution Policy</u>  | 119         |
| <u>Description of the Debt Securities</u>  | 126         |
| <u>Selling Unitholders</u>   | 138         |
| <u>Material Tax Considerations</u>   | 140         |
| <u>Investment in Us by Employee Benefit Plans</u>  | 157         |
| <u>Plan of Distribution</u>  | 158         |
| <u>Legal Matters</u>   | 159         |
| <u>Experts</u>   | 159         |
| <u>Where You Can Find More Information</u>   | 161         |
| <u>Index to Financial Statements</u>   | F-1         |

You should rely only on the information contained in this prospectus, any prospectus supplement and the documents we have incorporated by reference. We have not authorized anyone else to give you different information. We are not offering these securities in any state where the offer is not permitted. You should not assume that the information in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front of those documents. We will disclose any material changes in our affairs in an amendment to this prospectus, a prospectus supplement or a future filing with the Securities and Exchange Commission incorporated by reference in this prospectus.

**Table of Contents**

**Index to Financial Statements**

**ABOUT THIS PROSPECTUS**

This prospectus is part of a registration statement on Form S-3 that we have filed with the Securities and Exchange Commission using a shelf registration process. Under this shelf registration process, we may sell, in one or more offerings, up to \$800,000,000 in total aggregate offering price of securities described in this prospectus. In addition, the selling unitholders named in this prospectus may offer and sell up to 1,988,846 common units under this prospectus. This prospectus provides you with a general description of us and the securities offered under this prospectus. Unless otherwise provided in a prospectus supplement, we will not receive any proceeds from sales of common units by the selling unitholders.

Each time we or a selling unitholder sells securities under this prospectus, we will provide a prospectus supplement that will contain specific information about the terms of that offering and the securities being offered. The prospectus supplement also may add to, update or change information in this prospectus. If there is any inconsistency between the information in this prospectus and any prospectus supplement, you should rely on the information in the prospectus supplement. You should read carefully this prospectus, any prospectus supplement and the additional information described below under the heading **Where You Can Find More Information**.

As used in this prospectus, **we**, **us** and **our** and similar terms mean either or both of Energy Transfer Partners, L.P. and Heritage Operating, L.P. and their subsidiaries, unless the context indicates otherwise.

**WHO WE ARE**

We are a publicly traded Delaware limited partnership formed in conjunction with our initial public offering as Heritage Propane Partners, L.P. in June 1996. We are engaged in the natural gas midstream business through our operating subsidiary, La Grange Acquisition, L.P., and in the retail propane marketing business through our operating subsidiary, Heritage Operating, L.P. Following the completion of our transaction in January 2004, in which we combined the retail propane operations of Heritage Propane Partners with the natural gas midstream operations of Energy Transfer Company, we changed our name to Energy Transfer Partners, L.P.

Through La Grange Acquisition, a Texas limited partnership formed in October 2002, our midstream operations are conducted under the name Energy Transfer Company. Energy Transfer Company's operations are concentrated in the Austin Chalk trend of southeast Texas, the Anadarko Basin of western Oklahoma and the Permian Basin of west Texas. Through our ownership of the Energy Transfer Company operations, we own or have an interest in approximately 4,500 miles of natural gas gathering and transportation pipelines, three natural gas processing plants connected to our gathering systems and seven natural gas treating facilities.

Energy Transfer Company's operations are divided into two business segments, consisting of the midstream segment and the transportation segment. The midstream segment operations are conducted primarily in the Southeast Texas System and the Elk City System, and focus on the gathering of natural gas from over 1,400 producing wells, the compression of natural gas to facilitate its flow through Energy Transfer Company's gathering systems, the treating of natural gas to remove impurities to ensure that the natural gas meets pipeline quality specifications, the processing of natural gas to extract natural gas liquids, and the marketing of natural gas and natural gas liquids to third parties. Our transportation segment focuses on the transportation of natural gas through the Oasis Pipeline, a 583-mile natural gas pipeline that directly

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connects the Waha Hub, a major natural gas market center located in the Permian Basin of west Texas to the Katy Hub, a major natural gas market center near Houston, Texas.

- 3 -

**Table of Contents**

**Index to Financial Statements**

Through Heritage Operating, we serve more than 650,000 customers from over 300 customer service locations in 31 states. Our propane operations extend from coast to coast, with concentrations in the western, upper midwestern, northeastern and southeastern regions of the United States.

Our partnership agreement limits our general partner's fiduciary duties to our unitholders and restricts the remedies available for actions taken by our general partner that might otherwise constitute breaches of fiduciary duty.

We maintain our principal executive offices at 8801 South Yale Avenue, Suite 310, Tulsa, Oklahoma 74137, and our telephone number is (918) 492-7272.

**Table of Contents**

**Index to Financial Statements**

**THE SUBSIDIARY GUARANTORS**

Energy Transfer Partners, L.P. will, and Heritage Service Corp., Heritage-Bi State, L.L.C. and Heritage Energy Resources, L.L.C. may, unconditionally guarantee any series of debt securities of Heritage Operating, L.P. offered by this prospectus, as set forth in a related prospectus supplement. Heritage Operating, L.P., Heritage Service Corp., Heritage-Bi State, L.L.C. and Heritage Energy Resources, L.L.C. may unconditionally guarantee any series of debt securities of Energy Transfer Partners, L.P. offered by this prospectus, as set forth in a related prospectus supplement. As used in this prospectus, the term **Subsidiary Guarantors** means Heritage Service Corp., Heritage-Bi State, L.L.C. and Heritage Energy Resources, L.L.C. and also includes Heritage Operating, L.P. when discussing subsidiary guarantees of the debt securities of Energy Transfer Partners, L.P. The term **Guarantor** means Energy Transfer Partners, L.P. in its role as guarantor of the debt securities of Heritage Operating, L.P.

- 5 -

**Table of Contents**

**Index to Financial Statements**

**RISK FACTORS**

*Limited partner interests are inherently different from the capital stock of a corporation, although many of the business risks to which we are subject are similar to those that would be faced by a corporation engaged in a similar business. Before you invest in our securities, you should consider carefully the following risk factors, together with all of the other information included in this prospectus, any prospectus supplement and the documents we have incorporated by reference.*

*If any of the following risks actually were to occur, our business, financial condition or results of operations could be affected materially and adversely. In that case, we may be unable to make distributions to our unitholders or pay interest on, or the principal of, any debt securities, the trading price of our securities could decline and you could lose all or part of your investment.*

**Risks Related to our Midstream and Transportation Business**

*The profitability of our midstream and transportation business is dependent upon prices and market demand for natural gas and NGLs, which are beyond our control and have been volatile.*

Our midstream and transportation business is subject to significant risks due to fluctuations in commodity prices. During the 11 months ended August 31, 2003, we generated approximately 54% of our gross margin from three types of contractual arrangements under which our margin is exposed to increases and decreases in the price of natural gas and NGLs—discount-to-index, percentage-of-proceeds and keep-whole arrangements.

For a portion of the natural gas gathered at the Southeast Texas System and the Elk City System, we purchase natural gas from producers at the wellhead at a price that is at a discount to a specified index price and then gather and deliver the natural gas to pipelines where we typically resell the natural gas at the index price. Generally, the gross margins we realize under these discount-to-index arrangements decrease in periods of low natural gas prices because these gross margins are based on a percentage of the index price. Accordingly, a decrease in the price of natural gas could have a material adverse effect on our results of operations.

For a portion of the natural gas gathered at the Southeast Texas System and the Elk City System, we enter into percentage-of-proceeds arrangements and keep-whole arrangements, pursuant to which we agree to gather and process natural gas received from the producers. Under percentage-of-proceeds arrangements, we generally sell the residue gas and NGLs at market prices and remit to the producers an agreed upon percentage of the proceeds based on an index price. In other cases, instead of remitting cash payments to the producer, we deliver an agreed upon percentage of the residue gas and NGL volumes to the producer and sell the volumes we keep to third parties at market prices. Under these arrangements our revenues and gross margins decline when natural gas prices and NGL prices decrease. Accordingly, a decrease in the price of natural gas or NGLs could have a material adverse effect on our results of operations. Under keep-whole arrangements, we generally sell the NGLs produced from our gathering and processing operations to third parties at market prices. Because the extraction of the NGLs from the natural gas during processing reduces the Btu content of the natural gas, we must either purchase natural gas at market prices for return to producers or make a cash payment to producers equal to the value of this natural gas. Under these arrangements, our revenues and gross margins decrease when the price of natural gas increases relative to the price of NGLs if we are not able to bypass our processing plants and sell the



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unprocessed natural gas. Accordingly, an increase in the price of natural gas relative to the price of NGLs could have a material adverse effect on our results of operations.

- 6 -

**Table of Contents**

**Index to Financial Statements**

In the past, the prices of natural gas and NGLs have been extremely volatile, and we expect this volatility to continue. For example, during the 11 months ended August 31, 2003, the NYMEX settlement price for the prompt month contract ranged from a high of \$9.58 per MMBtu to a low of \$3.72 per MMBtu. A composite of the Mt. Belvieu average NGLs price based upon our average NGLs composition during the 11 months ended August 31, 2003 ranged from a high of approximately \$0.82 per gallon to a low of approximately \$0.41 per gallon.

Average realized natural gas sales prices for the 11 months ended August 31, 2003 substantially exceeded our historical realized natural gas prices as well as recent natural gas prices. For example, our average realized natural gas price increased \$2.31, or 85.0%, from \$2.72 per MMBtu for the nine months ended September 30, 2002 to \$5.03 per MMBtu for the 11 months ended August 31, 2003. On December 13, 2003, the NYMEX settlement price for January natural gas deliveries was \$6.95 per MMBtu, which was 38.2% higher than our average natural gas price for the 11 months ended August 31, 2003. Natural gas prices are subject to significant fluctuations, and there can be no assurance that natural gas prices will remain at the high level recently experienced.

The markets and prices for residue gas and NGLs depend upon factors beyond our control. These factors include demand for oil, natural gas and NGLs, which fluctuate with changes in market and economic conditions, and other factors, including:

- the impact of weather on the demand for oil and natural gas;
- the level of domestic oil and natural gas production;
- the availability of imported oil and natural gas;
- actions taken by foreign oil and gas producing nations;
- the availability of local, intrastate and interstate transportation systems;
- the availability and marketing of competitive fuels;
- the impact of energy conservation efforts; and
- the extent of governmental regulation and taxation.

***Our success depends upon our ability to continually find and contract for new sources of natural gas supply.***

In order to maintain or increase throughput levels on our gathering and transportation pipeline systems and asset utilization rates at our treating and processing plants, we must continually contract for new natural gas supplies. We may not be able to obtain additional contracts for natural gas supplies. The primary factors affecting our ability to connect new supplies of natural gas to our gathering systems include our success in

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contracting for existing natural gas supplies that are not committed to other systems and the level of drilling activity near our gathering systems. The primary factors affecting our ability to attract customers to the Oasis Pipeline include our access to other natural gas pipelines, natural gas markets, natural gas-fired power plants and other industrial end-users and the level of drilling in areas connected to the Oasis Pipeline.

- 7 -

**Table of Contents**

**Index to Financial Statements**

Fluctuations in energy prices can greatly affect production rates and investments by third parties in the development of new oil and natural gas reserves. Drilling activity generally decreases as oil and natural gas prices decrease. We have no control over the level of drilling activity in the areas of operations, the amount of reserves underlying the wells and the rate at which production from a well will decline, sometimes referred to as the decline rate. In addition, we have no control over producers or their production decisions, which are affected by, among other things, prevailing and projected energy prices, demand for hydrocarbons, the level of reserves, geological considerations, governmental regulation and the availability and cost of capital.

A substantial portion of our assets, including our gathering systems and our processing and treating plants, are connected to natural gas reserves and wells for which the production will naturally decline over time. In particular, the Southeast Texas System covers portions of the Austin Chalk, Buda, Georgetown, Edwards, Wilcox and other producing formations in southeast Texas, which we collectively refer to as the Austin Chalk trend, and the Elk City System covers portions of the Anadarko basin in western Oklahoma. Both of these natural gas producing regions have generally been characterized by high initial flow rates followed by steep initial declines in production. Accordingly, our cash flows associated with these systems will also decline unless we are able to access new supplies of natural gas by connecting additional production to these systems. A material decrease in natural gas production in our areas of operation, as a result of depressed commodity prices or otherwise, would result in a decline in the volume of natural gas we handle, which would reduce our revenues and operating income. In addition, our future growth will depend, in part, upon whether we can contract for additional supplies at a greater rate than the rate of natural decline in our currently connected supplies.

*We depend on certain key producers for our supply of natural gas on the Southeast Texas System and the Elk City System, the loss of any of these key producers could adversely affect our financial results.*

For the 11 months ended August 31, 2003, Anadarko Petroleum Corp. and Chesapeake Energy Corp. supplied us with approximately 44% of the Southeast Texas System's natural gas supply, and Chesapeake Energy Corp. and Kaiser-Francis Oil Company and its affiliates supplied us with approximately 53% of the Elk City System's natural gas supply. To the extent that these and other producers may reduce the volumes of natural gas that they supply us, we would be adversely affected unless we were able to acquire comparable supplies of natural gas from other producers.

*Federal, state or local regulatory measures could adversely affect our business.*

As a natural gas gatherer and intrastate pipeline company, we are generally exempt from Federal Energy Regulatory Commission, or FERC, regulation under the Natural Gas Act of 1938, or NGA, but FERC regulation still significantly affects our business and the market for our products. In recent years, FERC has pursued pro-competitive policies in our regulation of interstate natural gas pipelines. However, we cannot assure you that FERC will continue this approach as it considers matters such as pipeline rates and rules and policies that may affect rights of access to natural gas transportation capacity. In addition, the rates, terms and conditions of some of the transportation services we provide on the Oasis Pipeline are subject to FERC regulation under Section 311 of the Natural Gas Policy Act, or NGPA. Under Section 311, rates charged for transportation must be fair and equitable, and amounts collected in excess of fair and equitable rates are subject to refund with interest.

**Table of Contents**

**Index to Financial Statements**

Our intrastate natural gas transportation pipelines are located in Texas and some are subject to regulation as common purchasers and as gas utilities by the Texas Railroad Commission, or TRRC. The TRRC's jurisdiction extends to both rates and pipeline safety. The rates we charge for transportation services are deemed just and reasonable under Texas law unless challenged in a complaint. Should a complaint be filed or should regulation become more active, our business may be adversely affected.

Other state and local regulations also affect our business. We are subject to ratable take and common purchaser statutes in Texas, Oklahoma and Louisiana, the states where we operate. Ratable take statutes generally require gatherers to take, without undue discrimination, natural gas production that may be tendered to the gatherer for handling. Similarly, common purchaser statutes generally require gatherers to purchase without undue discrimination as to source of supply or producer. These statutes have the effect of restricting our right as an owner of gathering facilities to decide with whom we contract to purchase or transport natural gas. Federal law leaves any economic regulation of natural gas gathering to the states, and some of the states in which we operate have adopted complaint-based or other limited economic regulation of natural gas gathering activities. States in which we operate that have adopted some form of complaint-based regulation, like Oklahoma and Texas, generally allow natural gas producers and shippers to file complaints with state regulators in an effort to resolve grievances relating to natural gas gathering rates and access.

The states in which we conduct operations administer federal pipeline safety standards under the Pipeline Safety Act of 1968, which requires certain pipelines to comply with safety standards in constructing and operating the pipelines, and subjects pipelines to regular inspections. Certain of our gathering facilities are exempt from the requirements of this Act. In respect to recent pipeline accidents in other parts of the country, Congress and the Department of Transportation have passed or are considering heightened pipeline safety requirements. See *Business Energy Transfer Company Regulation*.

Failure to comply with applicable regulations under the NGA, NGPA, Pipeline Safety Act and certain state laws can result in the imposition of administrative, civil and criminal remedies.

***Our business involves hazardous substances and may be adversely affected by environmental regulation.***

Many of the operations and activities of our gathering systems, plants and other facilities are subject to significant federal, state and local environmental laws and regulations. These include, for example, laws and regulations that impose obligations related to air emissions and discharge of wastes from our facilities and the cleanup of hazardous substances that may have been released at properties currently or previously owned or operated by us or locations to which we have sent wastes for disposal. Various governmental authorities have the power to enforce compliance with these regulations and the permits issued under them, and violators are subject to administrative, civil and criminal penalties, including civil fines, injunctions or both. Liability may be incurred without regard to fault for the remediation of contaminated areas. Private parties, including the owners of properties through which our gathering systems pass, may also have the right to pursue legal actions to enforce compliance as well as to seek damages for non-compliance with environmental laws and regulations or for personal injury or property damage.

There is inherent risk of the incurrence of environmental costs and liabilities in our business due to our handling of natural gas and other petroleum products, air emissions related to our operations, historical industry operations, waste disposal practices and the prior use of natural gas flow meters containing mercury. In addition, the possibility exists that stricter laws, regulations or enforcement policies could significantly increase



**Table of Contents**

**Index to Financial Statements**

our compliance costs and the cost of any remediation that may become necessary. We may incur material environmental costs and liabilities. Furthermore, our insurance may not provide sufficient coverage in the event an environmental claim is made against us.

Our business may be adversely affected by increased costs due to stricter pollution control requirements or liabilities resulting from non-compliance with required operating or other regulatory permits. New environmental regulations might adversely affect our products and activities, including gathering, compression, treating, processing and transportation, as well as waste management and air emissions. Federal and state agencies could also impose additional safety requirements, any of which could affect our profitability. See Business Energy Transfer Company Environmental Matters.

*Our business involves many hazards and operational risks, some of which may not be fully covered by insurance.*

Our operations are subject to the many hazards inherent in the gathering, compression, treating, processing and transportation of natural gas and NGLs, including:

damage to pipelines, related equipment and surrounding properties caused by hurricanes, tornadoes, floods, fires and other natural disasters and acts of terrorism;

inadvertent damage from construction and farm equipment;

leaks of natural gas, NGLs and other hydrocarbons; and

fires and explosions.

These risks could result in substantial losses due to personal injury and/or loss of life, severe damage to and destruction of property and equipment and pollution or other environmental damage and may result in curtailment or suspension of our related operations. Our operations are primarily concentrated in Texas, and a natural disaster or other hazard affecting this area could have a material adverse effect on our operations. We are not fully insured against all risks incident to our business. We do not have property insurance on all of our underground pipeline systems that would cover damage to the pipelines. We are not insured against all environmental accidents that might occur, other than those considered to be sudden and accidental. We have minimal business interruption insurance that covers the Oasis Pipeline. Under the terms of our general liability and workers compensation policies, claims of up to \$1 million are insured. We also have excess liability coverage for claims up to \$35 million per occurrence after the payment of a \$1 million deductible. If a significant accident or event occurs that is not fully insured, it could adversely affect our operations and financial condition.

*Any reduction in the capacity of, or the allocations to, our shippers in interconnecting, third-party pipelines could cause a reduction of volumes transported in our pipelines, which would adversely affect our revenues and cash flow.*

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Users of our pipelines are dependent upon connections to third-party pipelines to receive and deliver natural gas and NGLs. Any reduction of capacities of these interconnecting pipelines due to testing, line repair, reduced operating pressures, or other causes could result in reduced volumes transported in our pipelines. Similarly, if

- 10 -



**Table of Contents**

**Index to Financial Statements**

additional shippers begin transporting volumes of natural gas and NGLs over interconnecting pipelines, the allocations to existing shippers in these pipelines would be reduced, which could also reduce volumes transported in our pipelines. Any reduction in volumes transported in our pipelines would adversely affect our revenues and cash flow.

*We encounter competition from other midstream companies.*

We experience competition in all of our markets. Our principal areas of competition include obtaining natural gas supplies for the Southeast Texas System and Elk City System and natural gas transportation customers for the Oasis Pipeline. Our competitors include major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas. The Oasis Pipeline competes directly with two other major intrastate pipelines that link the Waha Hub and the Houston area, one of which is owned by Duke Energy Field Services, LLC and the other one of which is owned by El Paso Corporation and American Electric Power Service Corporation. The Southeast Texas System competes with natural gas gathering and processing systems owned by Duke Energy Field Services, LLC and Devon Energy Corporation. The Elk City System competes with natural gas gathering and processing systems owned by Enogex, Inc., Oneok Gas Gathering, L.L.C., CenterPoint Energy Field Services, Inc. and Enbridge Inc., as well as producer owned systems. Many of our competitors have greater financial resources and access to larger natural gas supplies than we do.

*Expanding our business by constructing new pipelines and treating and processing facilities subjects us to construction risks.*

One of the ways we may grow our business is through the construction of additions to our existing gathering, compression, treating, processing and transportation system. The construction of a new pipeline or the expansion of an existing pipeline, by adding additional horsepower or pump stations or by adding a second pipeline along an existing pipeline, and the construction of new processing or treating facilities, involve numerous regulatory, environmental, political and legal uncertainties beyond our control and require the expenditure of significant amounts of capital. If we undertake these projects, they may not be completed on schedule or at all or at the budgeted cost. Moreover, our revenues may not increase immediately upon the expenditure of funds on a particular project. For instance, if we build a new pipeline, the construction will occur over an extended period of time, and we will not receive any material increases in revenues until after completion of the project. Moreover, we may construct facilities to capture anticipated future growth in production in a region in which such growth does not materialize. As a result, new facilities may not be able to attract enough throughput to achieve our expected investment return, which could adversely affect our results of operations and financial condition.

*We depend on Koch Hydrocarbons, L.P. to purchase and fractionate the NGLs produced at the Elk City processing plant.*

All of the NGLs produced at the Elk City processing plant are transported by Koch Hydrocarbons and delivered for fractionation to Conway, Kansas. There are no other fractionation plants or other NGL markets connected to the Elk City processing plant. As a result, if Koch Hydrocarbons refuses or is unable to transport or fractionate these NGLs, our only alternative in the short term would be to transport NGLs by truck to another fractionation plant or another NGL market, which would likely result in additional costs and adversely affect our ability to market the NGLs.

**Table of Contents**

**Index to Financial Statements**

*We are exposed to the credit risk of our customers, and an increase in the nonpayment and nonperformance by our customers could reduce our ability to make distributions to our unitholders.*

Risks of nonpayment and nonperformance by our customers are a major concern in our business. Several participants in the energy industry have been receiving heightened scrutiny from the financial markets in light of the collapse of Enron Corp. We are subject to risks of loss resulting from nonpayment or nonperformance by our customers. Any increase in the nonpayment and nonperformance by our customers could reduce our ability to make distributions to our unitholders.

*We may not be able to bypass the La Grange processing plant, which would expose us to the risk of unfavorable processing margins.*

Because of our ownership of the Oasis Pipeline, we can generally elect to bypass the La Grange processing plant when processing margins are unfavorable and instead deliver pipeline-quality gas by blending rich gas from the Southeast Texas System with lean gas transported on the Oasis Pipeline. In some circumstances, such as when we do not have a sufficient amount of lean gas to blend with the volume of rich gas that we receive at the La Grange processing plant, we may have to process the rich gas. If we have to process when processing margins are unfavorable, our results of operations will be adversely affected.

*We may not be able to retain existing customers or acquire new customers, which would reduce our revenues and limit our future profitability.*

The renewal or replacement of existing contracts with our customers at rates sufficient to maintain current revenues and cash flows depends on a number of factors beyond our control, including competition from other pipelines, and the price of, and demand for, natural gas in the markets we serve.

For the 11 months ended August 31, 2003, approximately 23% of our sales of natural gas were to industrial end-users and utilities. As a consequence of the increase in competition in the industry and volatility of natural gas prices, end-users and utilities are increasingly reluctant to enter into long-term purchase contracts. Many end-users purchase natural gas from more than one natural gas company and have the ability to change providers at any time. Some of these end-users also have the ability to switch between gas and alternate fuels in response to relative price fluctuations in the market. Because there are numerous companies of greatly varying size and financial capacity that compete with us in the marketing of natural gas, we often compete in the end-user and utilities markets primarily on the basis of price. The inability of our management to renew or replace our current contracts as they expire and to respond appropriately to changing market conditions could have a negative effect on our profitability.

*Energy Transfer Company has a limited operating history.*

Energy Transfer Company acquired substantially all of its assets in October 2002 and December 2002 and has therefore only operated them together under common management for a limited period of time. Furthermore, the success of our business strategy related to our midstream and transportation business is dependent upon our operating these assets substantially differently from the manner in which Aquila Gas Pipeline operated them. As a result, our historical and pro forma financial information may not give you an accurate indication of what our actual results

would have been if we had completed the acquisitions at the

**Table of Contents**

**Index to Financial Statements**

beginning of the periods presented or our future results of operations. If we are unable to operate these assets in accordance with our business strategy, it will have a material adverse effect on our results of operations.

**Risks Related to Our Propane Business**

*Since weather conditions may adversely affect demand for propane, our financial condition is vulnerable to warm winters.*

Weather conditions have a significant impact on the demand for propane for both heating and agricultural purposes because many of our customers rely heavily on propane as a heating fuel. Typically, we sell approximately two-thirds of our retail propane volume during the peak-heating season of October through March. Our results of operations can be adversely affected by warmer winter weather which results in lower sales volumes. In addition, to the extent that warm weather or other factors adversely affect our operating and financial results, our access to capital and our acquisition activities may be limited. Variations in weather in one or more of the regions where we operate can significantly affect the total volume of propane that we sell and the profits realized on these sales. Agricultural demand for propane is also affected by weather during the harvest season as poor harvests or dry weather reduce demand for propane used in crop drying.

*Sudden and sharp propane price increases that cannot be passed on to customers may adversely affect our profit margins.*

The propane industry is a margin-based business in which gross profits depend on the excess of sales prices over supply costs. As a result, our profitability is sensitive to changes in energy prices, and in particular, changes in wholesale prices of propane. When there are sudden and sharp increases in the wholesale cost of propane, we may not be able to pass on these increases to our customers through retail or wholesale prices. Propane is a commodity and the price we pay for it can fluctuate significantly in response to changes in supply or other market conditions over which we have no control. In addition, the timing of cost pass-throughs can significantly affect margins. Sudden and extended wholesale price increases could reduce our gross profits and could, if continued over an extended period of time, reduce demand by encouraging our retail customers to conserve or convert to alternative energy sources.

*Our results of operations and our ability to make distributions or pay interest or principal on debt securities could be negatively impacted by price and inventory risk and management of these risks.*

We generally attempt to minimize our price and inventory risk by purchasing product on a short-term basis, under supply contracts that typically have a one-year term and at a price that fluctuates based on the prevailing market prices at major delivery points. In order to help ensure adequate supply sources are available during periods of high demand, we may purchase large volumes of propane during periods of low demand or low price, which generally occur during the summer months, for storage in our facilities, at major storage facilities or for future delivery. This strategy may not be effective in limiting our price and inventory risks if, for example, market, weather or other conditions prevent or allocate the delivery of physical product during periods of peak demand. If the market price falls below the price at which we made such purchases, it could adversely affect our profits.

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Some of our propane sales are pursuant to commitments at fixed prices. To mitigate the price risk related to our anticipated sales volumes under the commitments, we may purchase and store physical product and/or enter

- 13 -

**Table of Contents**

**Index to Financial Statements**

into fixed price over-the-counter energy commodity forward contracts and options. Generally, over-the-counter energy commodity forward contracts have terms of less than one year. We enter into such contracts and exercise such options at volume levels that we believe are necessary to manage these commitments. The risk management of our inventory and contracts for the future purchase of product could impair our profitability if the customers do not fulfill their obligations.

We also engage in other trading activities, and may enter into other types of over-the-counter energy commodity forward contracts and options. These trading activities are based on our management's estimates of future events and prices and are intended to generate a profit. However, if those estimates are incorrect or other market events outside of our control occur, such activities could generate a loss in future periods and potentially impair our profitability.

*We are dependent on our principal suppliers, which increases the risk of an interruption in supply.*

During fiscal 2003, we purchased approximately 29% of our propane from Enterprise Products Operating L.P., approximately 13% of our propane from Dynegy Liquids Marketing and Trade and approximately 19% of our propane from MP Energy, the Canadian partnership in which we own a 60% interest. If supplies from these sources were interrupted, the cost of procuring replacement supplies and transporting those supplies from alternative locations might be materially higher and, at least on a short-term basis, margins could be adversely affected. Supply from Canada is subject to the additional risk of disruption associated with foreign trade such as trade restrictions, shipping delays and political, regulatory and economic instability.

Historically, a substantial portion of the propane we purchase has originated from one of the industry's major markets located in Mont Belvieu, Texas and has been shipped to us through major common carrier pipelines. Any significant interruption in the service at Mont Belvieu or other major market points, or on the common carrier pipelines we use would adversely affect our ability to obtain propane.

*Because of the highly competitive nature of the retail propane business, we may not be able to maintain existing customers or acquire new customers, which would have an adverse impact on our operating results and financial condition.*

We compete with a number of large national and regional propane companies, some of whom have greater financial resources than we do, and several thousand small independent propane companies. Because of the relatively low barriers to entry into the retail propane market, there is potential for small independent propane retailers, as well as other companies that may not be engaged in retail propane distribution, to compete with our retail outlets. As a result, we are always subject to the risk of additional competition in the future. Generally, warmer-than-normal weather further intensifies competition. Most of our propane retail branch locations compete with several other marketers or distributors in their service areas. The principal factors influencing competition with other retail marketers are:

price,

reliability and quality of service,

responsiveness to customer needs,

- 14 -

**Table of Contents**

**Index to Financial Statements**

safety concerns,

long-standing customer relationships,

the inconvenience of switching tanks and suppliers, and

the lack of growth in the industry.

We can make no assurances that we will be able to compete successfully on the basis of these factors.

***Competition from alternative energy sources may cause us to lose customers, thereby reducing our revenues.***

Competition from alternative energy sources has been increasing as a result of reduced regulation of many utilities. Propane is generally not competitive with natural gas in areas where natural gas pipelines already exist because natural gas is a less expensive source of energy than propane. The gradual expansion of natural gas distribution systems and the availability of natural gas in many areas that previously depended upon propane could cause us to lose customers, thereby reducing our revenues. Fuel oil also competes with propane and is generally less expensive than propane. In addition, the successful development and increasing usage of alternative energy sources could adversely affect our operations.

***If we do not continue to make acquisitions on economically acceptable terms, our future financial performance will be limited.***

The propane industry is not a growth industry in part because of increased competition from alternative energy sources. In addition, because of long-standing customer relationships that are typical in the retail propane industry, the inconvenience of switching tanks and suppliers, and propane's higher cost relative to other energy sources, such as natural gas, we may have difficulty in increasing our retail customer base except through acquisitions. Therefore, our ability to grow our propane business will depend primarily upon our ability to acquire other retail propane distributors. Any acquisition may involve one or more of the following risks, including:

an increase in our indebtedness, which may affect credit ratings and our ability to make distributions to unitholders;

the inability to integrate the operations of the acquired business into our existing operations and make cost-saving changes such that the acquisition will be accretive to earnings and distributions to unitholders;

the diversion of management's attention from other business concerns;



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the assumption of unknown liabilities and/or the inability or failure of the sellers to indemnify us under the acquisition agreements;  
and

greater-than-expected loss of customers or employees from the acquired business.

- 15 -

**Table of Contents**

**Index to Financial Statements**

*Covenant restrictions in the debt agreements of Heritage Operating may limit its ability to incur indebtedness, grant liens and take other actions.*

Heritage Operating is subject to restrictive covenants contained in its debt agreements. These debt agreements consist of a bank credit facility and the three note agreements with secured lenders. These covenants limit the ability of Heritage Operating to incur additional indebtedness, grant liens on our properties or assets, or make loans, advances, investments and engage in transactions with affiliates. In addition, these covenants require Heritage Operating to maintain ratios of consolidated funded indebtedness to consolidated EBITDA (as these terms are similarly defined in the debt agreements) of not more than 5.00 to 1 for the bank credit facility and not more than 5.25 to 1 for the note agreements and consolidated EBITDA to consolidated interest expense (as these terms are similarly defined in the debt agreements) of not less than 2.25 to 1.

*We are subject to operating and litigation risks that could adversely affect our operating results.*

Our operations are subject to all operating hazards and risks normally incidental to handling, storing and delivering combustible liquids like propane. As a result, we have been, and are likely to be, a defendant in various legal proceedings arising in the ordinary course of business. Our insurance may not be adequate to protect us from all material expenses related to potential future claims for personal injury and property damage and we may not be able to continue purchasing such levels of insurance at economical prices. In addition, the occurrence of a serious accident involving propane, whether or not we are involved, may have an adverse effect on the public's desire to use propane.

*Energy efficiency and technological advances may affect the demand for propane and adversely affect our operating results.*

The national trend toward increased conservation and technological advances, including installation of improved insulation and the development of more efficient furnaces and other heating devices, has decreased the demand for propane by retail customers. Stricter conservation measures in the future or technological advances in heating, conservation, energy generation or other devices could adversely affect our operations.

*Due to our lack of asset diversification, adverse developments in our propane business would reduce our ability to make distributions to our unitholders.*

Due to our lack of asset diversification, an adverse development in our propane business would have a significantly greater impact on our financial condition and results of operations than if we maintained more diverse assets.

**Risks Inherent in an Investment in Us**

*Cash distributions are not guaranteed and may fluctuate with our performance and other external factors.*

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The amount of cash we can distribute on our common units or other partnership securities depends upon the amount of cash we generate from our operations. The amount of cash we generate from our operations will fluctuate from quarter to quarter and will depend upon, among other things:

the amount of natural gas transported on the Oasis Pipeline and in our gathering systems;

the level of throughput in our processing and treating operations;

- 16 -

**Table of Contents**

**Index to Financial Statements**

the fees we charge and the margins we realize for our services;

the price of natural gas;

the relationship between natural gas and NGL prices;

the weather in our operating areas;

the cost to us of the propane we buy for resale and the prices we receive for our propane;

the level of competition from other propane companies and other energy providers;

the level of our operating costs; and

prevailing economic conditions.

In addition, the actual amount of cash available for distribution will also depend on other factors, such as:

the level of capital expenditures we make;

the cost of acquisitions, if any;

our debt service requirements;

fluctuations in our working capital needs;

our ability to make working capital borrowings under our credit facilities to make distributions;

restrictions on distributions contained in our debt agreements; and

the amount, if any, of cash reserves established by the general partner in its discretion for the proper conduct of our business.

Because of all these factors, we cannot guarantee that we will have sufficient available cash to pay a specific level of cash distributions to our unitholders.

Furthermore, you should be aware that the amount of cash we have available for distribution depends primarily upon our cash flow, including cash flow from financial reserves and working capital borrowings, and is not solely a function of profitability, which will be affected by non-cash items. As a result, we may make cash distributions during periods when we record net losses and may not make cash distributions during periods when we record net income.

*We may be unable to successfully integrate the operations of Energy Transfer Company with our operations and to realize all of the anticipated benefits of the acquisition of Energy Transfer Company.*

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**Table of Contents**

**Index to Financial Statements**

In January 2004, we completed a combination transaction with La Grange Acquisition, L.P. (a company that conducted its operations under the name Energy Transfer Company). This combination involves the integration of two companies in separate lines of business that previously have operated independently, which is a complex, costly and time-consuming process. Failure to successfully integrate these two companies may have a material adverse effect on our business, financial condition or results of operations. The difficulties of combining the companies include, among other things:

operating a significantly larger combined company and adding a new business segment, midstream operations, to our existing propane operations;

the necessity of coordinating geographically disparate organizations, systems and facilities;

integrating personnel with diverse business backgrounds and organizational cultures; and

consolidating corporate and administrative functions.

Combining the two companies is made particularly difficult by the large size of Energy Transfer Company as compared to Heritage Propane Partners, L.P. (our predecessor company). For example, Energy Transfer Company's pro forma revenues for the 12 months ended August 31, 2003 were approximately \$1.1 billion as compared to revenues of Heritage Propane Partners, L.P. of approximately \$571 million for the same period. Additionally, the two companies operate in distinct business segments that require different operating strategies and different managerial expertise. The management team of Heritage Propane Partners, L.P. does not have substantial experience operating in the midstream natural gas industry. Likewise, the management team of Energy Transfer Company does not have substantial experience operating in the propane industry. While we intend to operate each of these two business segments independently by management experienced in such segments, we cannot assure you that this approach will be successful.

The process of combining the two companies could cause an interruption of, or loss of momentum in, the activities of the combined company's business and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with the acquisition and the integration of the two companies could harm the business, results of operations, financial condition or prospects of the combined company after the acquisition. Furthermore, the integration of these two companies may not result in the realization of the full benefits anticipated by the companies to result from the acquisition.

***As part of the Energy Transfer Transaction, La Grange Energy acquired our general partner and a large portion of our units. As a result, our management and business strategies changed substantially from our previous management and business strategies, which has an impact on an investment in our common units.***

In connection with the Energy Transfer Transaction, La Grange Energy purchased all of the partnership interests of U.S. Propane, L.P., our general partner, and all of the member interests of U.S. Propane, L.L.C., the general partner of U.S. Propane, L.P. In addition, La Grange Energy now owns 41.6% of our common units (assuming the conversion of the class D units and special units into common units). As a result of La Grange Energy's purchase of our general partner, La Grange Energy has made various changes to our management structure. La Grange Energy was formed to invest in the midstream natural gas industry and is the current owner of Energy Transfer Company, a midstream natural gas business. As the owner of our general partner, La Grange Energy has significant influence over our business strategy. La Grange Energy and our new



**Table of Contents**

**Index to Financial Statements**

management team may have different business strategies and approaches to operating our partnership than the previous owners of our general partner and our previous management team. In particular, we expect that midstream acquisitions will be the primary focus of our acquisition strategy in the future. Failure to successfully implement these new business strategies and operating approaches may have a material adverse effect on our business, financial condition and results of operations.

***We may sell additional limited partner interests, diluting existing interests of unitholders.***

Our partnership agreement allows us to issue an unlimited number of additional limited partner interests, including securities senior to the common units, without the approval of the unitholders. The issuance of additional common units or other equity securities will have the following effects:

the proportionate ownership interest of our unitholders in us will decrease;

the amount of cash available for distribution on each common unit or partnership security may decrease;

the relative voting strength of each previously outstanding common unit may be diminished; and

the market price of the common units or partnership securities may decline.

***La Grange Energy may sell units or other limited partner interests in the trading market, which could reduce the market price of unitholders' limited partner interests.***

La Grange Energy owns approximately 4,419,177 common units, 7,721,542 class D units and 3,742,515 special units. Following the approval of our unitholders and other conditions, the class D units and special units will be converted into an equal number of common units. In the future, La Grange Energy may dispose of some or all of these units. If La Grange Energy were to dispose of a substantial portion of these units in the trading markets, it could reduce the market price of our outstanding common units. Our partnership agreement allows La Grange Energy to cause us to register for sale units held by La Grange Energy. These registration rights allow La Grange Energy to request registration of its common units, class D units and special units and to include any of those units in a registration of other securities by us.

***Our debt agreements may limit our ability to make distributions to unitholders and our financial flexibility.***

As of August 31, 2003, Heritage Operating had outstanding \$353.1 million in senior secured debt with insurance companies and \$51.4 million in secured debt under its bank credit facility. This leverage may adversely affect its ability to finance future operations and capital needs, limit its ability to pursue acquisitions and other business opportunities and make its results of operations more susceptible to adverse economic conditions. Heritage Operating may in the future incur additional debt to finance acquisitions or for general business purposes, which could result in a significant increase in its leverage. The payment of principal and interest on its debt will reduce the cash available to make distributions on the common units. We will not be able to make any distributions to our unitholders if there is or will be an event of default under



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these debt agreements. The ability of Heritage Operating to make principal and interest payments depends on its future performance, which is subject to many factors, several of which will be outside its control. Heritage Operating has granted liens on substantially all of its personal property (other than vehicles) to secure its existing debt. If an event of default occurs, the secured lenders can foreclose on the collateral.

- 19 -

**Table of Contents**

**Index to Financial Statements**

The debt agreements of Heritage Operating contain provisions relating to changes in ownership and changes of our general partner. If these provisions are triggered, the outstanding debt under these agreements may become due. If that happens, we cannot guarantee that we would be able to pay the debt. The general partner and its partners are not prohibited from entering into a transaction that would trigger these change-in-ownership provisions. The notes and the bank credit facility also contain restrictive covenants that limit the ability of Heritage Operating to incur additional debt and to engage in certain transactions. The debt agreements contain covenants that require Heritage Operating to maintain ratios of consolidated funded indebtedness to consolidated EBITDA (as these terms are similarly defined in the debt agreements) of not more than 5.00 to 1 for the bank credit facility and not more than 5.25 to 1 for the note agreements and consolidated EBITDA to consolidated interest expense (as these terms are similarly defined in the debt agreements) of not less than 2.25 to 1. Other covenants also limit the ability of Heritage Operating to incur additional indebtedness, grant liens on its properties or assets, or make loans, advances, investments and engage in transactions with affiliates. These covenants could reduce its ability to capitalize on business opportunities as they arise. Any new indebtedness could be reasonably expected to have similar or greater restrictions.

Our ability to access the capital markets for future offerings may be limited by adverse market conditions resulting from, among other things, general economic conditions, contingencies and uncertainties that are difficult to predict and beyond our control. If we are unable to access the capital markets for future offerings, we might be forced to seek extensions for some of our short-term maturities or to refinance some of our debt obligations through bank credit, as opposed to long-term public or private debt securities or equity securities. The price and terms upon which we might receive such extensions or additional bank credit could be more onerous than those contained in our existing debt agreements. Any such arrangements could, in turn, increase the risk that our leverage may adversely affect our future financial and operating flexibility.

*The general partner is not elected by the unitholders and cannot be removed without its consent.*

Unlike the holders of common stock in a corporation, unitholders have only limited voting rights on matters affecting our business, and therefore limited ability to influence management's decisions regarding our business. Unitholders did not elect our general partner and will have no right to elect our general partner on an annual or other continuing basis. Although our general partner has a fiduciary duty to manage us in a manner beneficial to Energy Transfer Partners, L.P. and the unitholders, the directors of our general partner and its general partner, U.S. Propane, L.L.C., have a fiduciary duty to manage the general partner and its general partner in a manner beneficial to the owners of those entities.

Furthermore, if the unitholders are dissatisfied with the performance of our general partner, they will have little ability to remove our general partner. The general partner generally may not be removed except upon the vote of the holders of 66 2/3% of the outstanding units voting together as a single class, including units owned by the general partner and its affiliates. Because the general partner and its affiliates currently hold approximately 25.7% of all the units, with an additional 11.0% of units held by our officers and directors, it will be difficult to remove the general partner without the consent of the general partner and our affiliates.

Furthermore, unitholders' voting rights are further restricted by the partnership agreement provision providing that any units held by a person that owns 20% or more of any class of units then outstanding, other than the general partner and its affiliates, cannot be voted on any matter.

**Table of Contents**

**Index to Financial Statements**

*The control of our general partner may be transferred to a third party without unitholder consent.*

The general partner may transfer its general partner interest to a third party in a merger or in a sale of all or substantially all of its assets without the consent of the unitholders. Furthermore, there is no restriction in the partnership agreement on the ability of the general partner of our general partner from transferring its general partner interest in our general partner to a third party. Any new owner of the general partner would be in a position to replace the officers of the general partner with its own choices and to control the decisions taken by such officers.

*Unitholders may be required to sell their units to the general partner at an undesirable time or price.*

If at any time less than 20% of the outstanding units of any class are held by persons other than the general partner and its affiliates, the general partner will have the right to acquire all, but not less than all, of those units at a price no less than their then-current market price. As a consequence, a unitholder may be required to sell his common units at an undesirable time or price. The general partner may assign this purchase right to any of its affiliates or to us.

*Cost reimbursements due our general partner may be substantial and reduce our ability to pay the distributions to unitholders.*

Prior to making any distributions on the units, we will reimburse our general partner for all expenses it has incurred on our behalf. In addition, our general partner and its affiliates may provide us with services for which we will be charged reasonable fees as determined by the general partner. The reimbursement of these expenses and the payment of these fees could adversely affect our ability to make distributions to the unitholders. Our general partner has sole discretion to determine the amount of these expenses and fees.

*Unitholders may have liability to repay distributions.*

Under certain circumstances unitholders may have to repay us amounts wrongfully returned or distributed to them. Under Delaware law, we may not make a distribution to you if the distribution causes our liabilities to exceed the fair value of our assets. Liabilities to partners on account of their partnership interests and non-recourse liabilities are not counted for purposes of determining whether a distribution is permitted. Delaware law provides that a limited partner who receives such a distribution and knew at the time of the distribution that the distribution violated Delaware law will be liable to the limited partnership for the distribution amount for three years from the distribution date. Under Delaware law, an assignee who becomes a substituted limited partner of a limited partnership is liable for the obligations of the assignor to make contributions to the partnership. However, such an assignee is not obligated for liabilities unknown to him at the time he or she became a limited partner if the liabilities could not be determined from the partnership agreement.

*Our partnership agreement limits our general partner's fiduciary duties to our unitholders and restricts the remedies available to unitholders for actions taken by our general partner that might otherwise constitute breaches of fiduciary duty.*

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Our partnership agreement contains provisions that waive or consent to conduct by our general partner and its affiliates that reduce the obligations to which our general partner would otherwise be held by state-law fiduciary duty standards. The following is a summary of the material restrictions contained in our partnership

- 21 -

**Table of Contents**

**Index to Financial Statements**

agreement on the fiduciary duties owed by our general partner to the limited partners. Our partnership agreement:

permits our general partner to make a number of decisions in its sole discretion. This entitles our general partner to consider only the interests and factors that it desires, and it has no duty or obligation to give any consideration to any interest of, or factors affecting, us, our affiliates or any limited partner;

provides that our general partner is entitled to make other decisions in its reasonable discretion ;

generally provides that affiliated transactions and resolutions of conflicts of interest not involving a required vote of unitholders must be fair and reasonable to us and that, in determining whether a transaction or resolution is fair and reasonable, our general partner may consider the interests of all parties involved, including its own. Unless our general partner has acted in bad faith, the action taken by our general partner shall not constitute a breach of its fiduciary duty; and

provides that our general partner and its officers and directors will not be liable for monetary damages to us, our limited partners or assignees for errors of judgment or for any acts or omissions if our general partner and those other persons acted in good faith.

In order to become a limited partner of our partnership, a common unitholder is required to agree to be bound by the provisions in the partnership agreement, including the provisions discussed above.

***The general partner's absolute discretion in determining the level of cash reserves may adversely affect our ability to make cash distributions to our unitholders.***

Our partnership agreement requires the general partner to deduct from operating surplus cash reserves that in its reasonable discretion are necessary to fund our future operating expenditures. In addition, the partnership agreement permits the general partner to reduce available cash by establishing cash reserves for the proper conduct of our business, to comply with applicable law or agreements to which we are a party or to provide funds for future distributions to partners. These cash reserves will affect the amount of cash available for distribution to unitholders.

***Our general partner has conflicts of interest and limited fiduciary responsibilities, which may permit our general partner to favor its own interests to the detriment of unitholders.***

Our general partner and its affiliates directly and indirectly own an aggregate limited partner interest of approximately 25.6% and our officers and directors own approximately 11.5% of the limited partner interests in us. Conflicts of interest could arise in the future as a result of relationships between our general partner and its affiliates, on the one hand, and us, on the other hand. As a result of these conflicts our general partner may favor its own interests and those of its affiliates over the interests of the unitholders. The nature of these conflicts includes the following considerations:

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Remedies available to unitholders for actions that might, without the limitations, constitute breaches of fiduciary duty. Unitholders are deemed to have consented to some actions and conflicts of interest that might otherwise be deemed a breach of fiduciary or other duties under applicable state law.

- 22 -

**Table of Contents**

**Index to Financial Statements**

Our general partner is allowed to take into account the interests of parties in addition to us in resolving conflicts of interest, thereby limiting its fiduciary duties to the unitholders.

Our general partner's affiliates are not prohibited from engaging in other businesses or activities, including those in direct competition with us.

Our general partner determines the amount and timing of asset purchases and sales, capital expenditures, borrowings and reserves, each of which can affect the amount of cash that is distributed to unitholders.

Our general partner determines whether to issue additional units or other equity securities of us.

Our general partner determines which costs are reimbursable by us.

Our general partner controls the enforcement of obligations owed to us by it.

Our general partner decides whether to retain separate counsel, accountants or others to perform services for us.

Our general partner is not restricted from causing us to pay it or its affiliates for any services rendered on terms that are fair and reasonable to us or entering into additional contractual arrangements with any of these entities on our behalf.

In some instances our general partner may borrow funds in order to permit the payment of distributions, even if the purpose or effect of the borrowing is to make incentive distributions.

**Tax Risks**

For a general discussion of the expected federal income tax consequences of owning and disposing of common units, see **Material Tax Considerations**.

*The IRS could treat us as a corporation for tax purposes, which would substantially reduce the cash available for distribution to unitholders.*

The anticipated after-tax economic benefit of an investment in our common units depends largely on our being treated as a partnership for federal income tax purposes. We have not requested, and do not plan to request, a ruling from the IRS on this or any other matter affecting us.

If we were treated as a corporation for federal income tax purposes, we would pay federal income tax on our income at the corporate tax rate, which is currently a maximum of 35% and we would likely pay state taxes as well. Distributions to unitholders would generally be taxed again as corporate distributions, and none of our income, gains, losses or deductions would flow through to unitholders. Because a tax would be

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imposed upon us as a corporation, our cash available for distribution to unitholders would be substantially reduced. Therefore, our treatment as a corporation would result in a material reduction in the after-tax return to the unitholders, likely causing a substantial reduction in the value of our common units.

- 23 -



**Table of Contents**

**Index to Financial Statements**

A change in current law or a change in our business could cause us to be treated as a corporation for federal income tax purposes or otherwise subject us to entity-level taxation. Our partnership agreement provides that, if a law is enacted or existing law is modified or interpreted in a manner that causes us to be treated as a corporation or otherwise subjects us to entity-level taxation for federal, state or local income tax purposes, then the minimum quarterly distribution and the target distribution levels will be adjusted to reflect that impact on us.

*A successful IRS contest of the federal income tax positions we take may adversely affect the market for common units and the costs of any contest will be borne by our unitholders and our general partner.*

We have not requested a ruling from the IRS with respect to any matter affecting us. The IRS may adopt positions that differ from the conclusions of our counsel expressed in this prospectus or from the positions we take. It may be necessary to resort to administrative or court proceedings to sustain our counsel's conclusions or the positions we take. A court may not concur with some or all of our counsel's conclusions or the positions we take. Any contest with the IRS may materially and adversely affect the market for our common units and the price at which they trade. In addition, the costs of any contest with the IRS, principally legal, accounting and related fees, will be indirectly borne by our unitholders and our general partner since such costs will reduce the amount of cash available for distribution.

*Unitholders may be required to pay taxes on their share of our income even if they do not receive any cash distributions from us.*

Unitholders will be required to pay federal income taxes and, in some cases, state and local income taxes on their share of our taxable income even if they do not receive any cash distributions from us. Unitholders may not receive cash distributions from us equal to their share of our taxable income or even equal to the actual tax liability that results from the taxation of their share of our taxable income.

*Only calendar year taxpayers may become partners.*

Only calendar year taxpayers may purchase common units. Any unitholder who is not a calendar year taxpayer will not be admitted to Energy Transfer Partners, L.P. as a partner, will not be entitled to receive distributions or federal income tax allocations from Energy Transfer Partners, L.P. and may only transfer these common units to a purchaser or other transferee.

*Tax gain or loss on disposition of common units could be different than expected.*

Unitholders who sell common units will recognize gain or loss equal to the difference between the amount realized and their tax basis in those common units. Prior distributions in excess of the total net taxable income allocated for a common unit that decreased a unitholder's tax basis in that common unit will, in effect, become taxable income to the unitholder if the common unit is sold at a price greater than the unitholder's tax basis in that common unit, even if the price is less than his original cost. A substantial portion of the amount the unitholder realizes, whether or not representing gain, will likely be ordinary income to the unitholder. Should the IRS successfully contest some positions we take, a unitholder could recognize more gain on the sale of common units than would be the case under those positions, without the benefit of decreased income in prior years. Also, unitholders who sell common units may incur a tax liability in excess of the amount of cash they receive from the sale.



**Table of Contents**

**Index to Financial Statements**

*Tax-exempt entities, regulated investment companies and foreign persons face unique tax issues from owning common units which may result in adverse tax consequences to them.*

Investment in common units by tax-exempt entities, including employee benefit plans and individual retirement accounts (known as IRAs), regulated investment companies (known as mutual funds) and non-U.S. persons raises issues unique to them. For example, virtually all of our income allocated to unitholders who are organizations exempt from federal income tax, may be unrelated business taxable income and will be taxable to them. Very little of our income will be qualifying income to a regulated investment company. Distributions to non-U.S. persons will be reduced by withholding taxes, at the highest applicable rate, and non-U.S. persons will be required to file federal income tax returns and generally pay tax on their share of our taxable income.

*Our registration as a tax shelter may increase the risk of an IRS audit of us or a unitholder.*

We are registered with the IRS as a tax shelter. Our tax shelter registration number is 96234000014. As a result, we may be audited by the IRS and tax adjustments could be made. Any unitholder owning less than a 1% profits interest in us has very limited rights to participate in the income tax audit process. Further, any adjustments in our tax returns will lead to adjustments in the unitholders' tax returns and may lead to audits of the unitholders' tax returns and adjustments of items unrelated to us. Unitholders will bear the cost of any expense incurred in connection with an examination of their personal tax returns and will indirectly bear a portion of the cost of an audit of us.

*We will treat each purchaser of common units as having the same tax benefits without regard to the units purchased. The IRS may challenge this treatment, which could adversely affect the value of the units.*

Because we cannot match transferors and transferees of common units, we will adopt depreciation and amortization positions that do not conform with all aspects of existing Treasury regulations. A successful IRS challenge to those positions could adversely affect the amount of tax benefits available to you. It also could affect the timing of these tax benefits or the amount of gain from the unitholder's sale of common units and could have a negative impact on the value of the common units or result in audit adjustments to the unitholder's tax returns. Please read Material Tax Considerations Tax Consequences of Unit Ownership Section 754 Election and Uniformity of Units.

*Unitholders likely will be subject to state and local taxes in states where they do not live as a result of an investment in the units.*

In addition to federal income taxes, the unitholders may be subject to other taxes, including state and local taxes, unincorporated business taxes and estate, inheritance or intangible taxes that are imposed by the various jurisdictions in which we do business or own property now or in the future, even if they do not live in any of those jurisdictions. We presently conduct business in 29 states. In the future, we may acquire property or do business in other states or in foreign jurisdictions. Unitholders may be required to file state and local income tax returns and pay state and local income taxes in some or all of the jurisdictions. Further, unitholders may be subject to penalties for failure to comply with those requirements. It is the responsibility of each unitholder to file all federal, state and local tax returns. Our counsel has not rendered an opinion on the state or local tax consequences of an investment in us.

**Table of Contents**

**Index to Financial Statements**

**Risks Relating to the Debt Securities**

References in these Risks Relating to the Debt Securities to we, us, and our means Energy Transfer Partners, L.P. and Heritage Operating, L.P.

*Energy Transfer Partners, L.P. is a holding company and conducts its operations through its subsidiaries and depends on cash flow from its subsidiaries to service any of its debt obligations.*

Energy Transfer Partners, L.P. conducts all of its operations through its subsidiaries and owns no significant assets other than the ownership interests in these subsidiaries. Therefore, the ability of Energy Transfer Partners, L.P. to make required payments on any debt securities it issues will depend on the performance of Heritage Operating, L.P. and its subsidiaries and their ability to distribute funds to Energy Transfer Partners, L.P. The ability of these subsidiaries to make such distributions may be restricted by, among other things, their debt agreements and applicable state partnership laws and other laws and regulations. Under Heritage Operating, L.P.'s debt agreements, Heritage Operating, L.P. is prohibited from making a distribution to us that would result in a default in its debt agreements. Heritage Operating, L.P. accounts for substantially all of our subsidiaries' outstanding indebtedness. Furthermore, applicable state partnership and limited liability company laws restrict our subsidiaries from making distributions to us that would result in their insolvency. Delaware corporate law also provides that Heritage Service Corp. may only declare dividends either out of its surplus or net profits. If Energy Transfer Partners, L.P. is unable to obtain the funds necessary to pay the principal amount at maturity of its debt securities, or to repurchase its debt securities upon the occurrence of a change of control, Energy Transfer Partners, L.P. may be required to adopt one or more alternatives, such as a refinancing of the debt securities. We cannot assure you that Energy Transfer Partners, L.P. would be able to so refinance its debt securities.

*Your right to receive payments on the securities is unsecured and will be effectively subordinated to our existing and future secured indebtedness and to indebtedness of any of our subsidiaries who do not guarantee the securities.*

Any debt securities, including any guarantees, issued by Energy Transfer Partners, L.P., Heritage Operating, L.P. or the Subsidiary Guarantors will be effectively subordinated to the claims of our secured creditors. In the event of the insolvency, bankruptcy, liquidation, reorganization, dissolution or winding up of the business of Energy Transfer Partners, L.P., Heritage Operating, L.P. or any Subsidiary Guarantors, their secured creditors would generally have the right to be paid in full before any distribution is made to the holders of the debt securities. Furthermore, if any of our subsidiaries do not guarantee the debt securities, the debt securities will be effectively subordinated to the claims of all creditors, including trade creditors and tort claimants, of those subsidiaries. In the event of the insolvency, bankruptcy, liquidation, reorganization, dissolution or winding up of the business of a subsidiary that is not a guarantor, creditors of that subsidiary would generally have the right to be paid in full before any distribution is made to the issuer of the debt securities or the holders of the debt securities. As of August 31, 2003, Energy Transfer Partners, L.P. had no outstanding indebtedness. Heritage Operating, L.P. had outstanding approximately \$404.2 million of secured indebtedness and approximately \$21.2 million of unsecured indebtedness. Our other subsidiaries had approximately \$300,000 of outstanding indebtedness, all of which is secured.

*A subsidiary guarantee could be deemed to be a fraudulent conveyance under certain circumstances, and a court may try to subordinate or void the subsidiary guarantees.*

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Under federal bankruptcy laws and comparable provisions of state fraudulent transfer laws, a guarantee by a subsidiary could be voided, or claims in respect of a guarantee could be subordinated to all other debts of that

- 26 -

**Table of Contents**

**Index to Financial Statements**

guarantor if, among other things, the guarantor, at the time it incurred the indebtedness evidenced by its guarantee, received less than reasonably equivalent fair value or fair consideration for the incurrence of such guarantee, and

was insolvent or rendered insolvent by reason of such incurrence;

was engaged in a business or transaction for which the guarantor's remaining assets constituted unreasonably small capital; or

intended to incur, or believed that it would incur, debts beyond its ability to pay such debts as they mature.

In addition, any payment by that subsidiary guarantor pursuant to its guarantee could be voided and required to be returned to the guarantor, or to a fund for the benefit of the creditors of the guarantor. The measures of insolvency for purposes of these fraudulent transfer laws will vary depending upon the law applied in any proceeding to determine whether a fraudulent transfer has occurred. Generally, however, a guarantor would be considered insolvent if:

the sum of its assets, including contingent liabilities, were greater than the fair saleable value of all of its assets;

the present fair saleable value of its assets were less than the amount that would be required to pay its procurable liability, including contingent liabilities, on its existing debts, as they become absolute or mature; or

it could not pay its debts as they become due.

***Energy Transfer Partners, L.P. and Heritage Operating, L.P. are required to distribute all of their available cash to their unitholders and are not required to accumulate cash for the purpose of meeting their future obligations to holders of their debt securities, which may limit the cash available to service those debt securities.***

The partnership agreements of Energy Transfer Partners, L.P. and Heritage Operating, L.P. require us to distribute all of our available cash each fiscal quarter to our partners. Available cash is generally defined to mean all cash on hand at the end of the quarter, plus certain working capital borrowings after the end of the quarter, less reserves established by the general partner in its sole discretion to provide for the proper conduct of our business (including reserves for future capital expenditures), to comply with applicable law or agreements, including debt agreements, or to provide funds for future distributions to partners. Depending on the timing and amount of our cash distributions to unitholders and because we are not required to accumulate cash for the purpose of meeting obligations to holders of any debt securities, such distributions could significantly reduce the cash available to us in subsequent periods to make payments on any debt securities.

Table of Contents

Index to Financial Statements

**FORWARD-LOOKING STATEMENTS**

Some of the information included in this prospectus, any prospectus supplement and the documents we incorporate by reference contain forward-looking statements. These statements discuss goals, intentions and expectations as to future trends, plans, events, results of operations or financial condition, or state other information relating to us, based on the current beliefs of our management as well as assumptions made by, and information currently available to, management. Words such as may, will, anticipate, believe, expect, estimate, intend, project and similar phrases or expressions identify forward-looking statements. When considering forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this prospectus, any prospectus supplement and the documents we have incorporated by reference.

Although we believe these forward-looking statements to be reasonable, they are based upon a number of assumptions, any or all of which ultimately may prove to be inaccurate. These statements are subject to numerous assumptions, uncertainties and risks including, but not limited to, the following:

the general economic conditions in the United States of America as well as the general economic conditions and currencies in foreign countries;

the political and economic stability of petroleum producing nations;

the effect of weather conditions on demand for propane;

the effectiveness of risk-management policies and procedures and the ability of our liquids marketing counterparties to satisfy their financial commitments;

energy prices generally and specifically, and the price of natural gas, the price of NGLs and the price of propane to the consumer compared to the price of alternative and competing fuels;

the general level of petroleum product demand and the availability and price of propane supplies;

our ability to obtain adequate supplies of propane for retail sale in the event of an interruption in supply or transportation and the availability of capacity to transport propane to market areas;

hazards or operating risks incidental to transporting, storing and distributing propane that may not be fully covered by insurance;

the maturity of the propane industry and competition from other propane distributors;

energy efficiencies and technological trends;

loss of key personnel;

the availability and cost of capital and our ability to access certain capital sources;

changes in laws and regulations to which we are subject, including tax, environmental, transportation and employment regulations;

the costs and effects of legal and administrative proceedings; and

our ability to successfully identify and consummate strategic acquisitions at purchase prices that are accretive to our financial results.



**Table of Contents**

**Index to Financial Statements**

These factors are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Our future results will depend upon various other risks and uncertainties, including, but not limited to, those detailed in our other filings with the SEC. For additional information, please read our other current filings with the SEC under the Exchange Act and the Securities Act. Other unknown or unpredictable factors also could have material adverse effects on our future results. You should not put undue reliance on any future-looking statements. When considering forward-looking statements, please review the risk factors described under Risk Factors beginning on page 3 of this prospectus.

**USE OF PROCEEDS**

Unless we specify otherwise in any prospectus supplement, we will use the net proceeds (after the payment of offering expenses and underwriting discounts and commissions) from the sale of securities for general partnership purposes, which may include, among other things:

paying or refinancing all or a portion of our indebtedness outstanding at the time; and

funding working capital, capital expenditures or acquisitions.

The actual application of proceeds from the sale of any particular offering of securities using this prospectus will be described in the applicable prospectus supplement relating to such offering. The precise amount and timing of the application of these proceeds will depend upon our funding requirements and the availability and cost of other funds.

We will not receive any of the proceeds from any sale of common units by the selling unitholders.

**RATIO OF EARNINGS TO FIXED CHARGES**

In August 2000, Heritage Propane Partners, L.P. acquired all of the propane operations of U.S. Propane, L.P., an entity that was formed when TECO Energy, Inc., AGL Resources, Inc., Piedmont Natural Gas Company, Inc., and Atmos Energy Corporation contributed each company's propane operations, Peoples Gas Company, AGL Propane, Inc., Piedmont Propane Company, and United Cities Propane Gas, Inc., respectively, to U.S. Propane, L.P. in exchange for equity interests in U.S. Propane, L.P. Simultaneously with the transaction, U.S. Propane, L.P. acquired all of the outstanding common stock of our former general partner, Heritage Holdings, Inc., thereby acquiring control of us. The transaction was accounted for as an acquisition using the purchase method of accounting with Peoples Gas Company being treated as the acquiror for accounting purposes as a result of Peoples Gas Company being the acquiror in the transaction that formed U.S. Propane, L.P. However, Heritage Propane Partners, L.P. is the surviving entity for legal purposes.

Because the fiscal year of Heritage Propane Partners, L.P. ended on August 31 and Peoples Gas Company had a fiscal year-end of December 31, the eight-month period ended August 31, 2000 was treated as a transition period under the rules of the Securities and Exchange Commission and is presented separately below. However, we continue to have an August 31 fiscal year-end.



**Table of Contents**

**Index to Financial Statements**

The table below sets forth the ratio of earnings to fixed charges of Heritage Propane Partners, L.P. and subsidiaries on a consolidated basis for the periods indicated. The ratio of earnings to fixed charges presented below for the years ending December 31, 1997, 1998 and 1999 includes information with respect to Heritage Propane Partners, L.P. (formerly Peoples Gas). The ratio of earnings to fixed charges presented below for the eight months ended August 31, 2000 includes information with respect to Heritage Propane Partners, L.P. (formerly Peoples Gas), and beginning August 10, 2000 the propane operations of U.S. Propane, L.P. and Heritage Propane Partners, L.P. (Predecessor Heritage).

On February 2004, Heritage Propane Partners, L.P. changed its name to Energy Transfer Partners, L.P.

**Ratio of Earnings to Fixed Charges (formerly Peoples Gas):**

|   | <u>Year Ended December 31,</u> |             |             | <u>Eight</u>      | <u>Year Ended August 31,</u> |             |             |
|---|--------------------------------|-------------|-------------|-------------------|------------------------------|-------------|-------------|
|   | <u>1997</u>                    | <u>1998</u> | <u>1999</u> | <u>Months</u>     | <u>2001</u>                  | <u>2002</u> | <u>2003</u> |
|   |                                |             |             | <u>Ended</u>      |                              |             |             |
|   |                                |             |             | <u>August 31,</u> |                              |             |             |
|   |                                |             |             | <u>2000</u>       |                              |             |             |
| <u>Ratio of Earnings to Fixed Charges</u> | 76.38x                         | 436.37x     | 242.25x     | (A)               | 1.53x                        | 1.12x       | 1.88x       |

(A) Earnings for the eight months ended August 31, 2000, were insufficient to cover fixed charges by \$3.5 million.

**Table of Contents**

**Index to Financial Statements**

The table below sets forth the ratio of earnings to fixed charges of Heritage Propane Partners, L.P. and subsidiaries (Predecessor Heritage) on a consolidated basis for the periods indicated and does not include information with respect to Peoples Gas or the propane operations of U.S. Propane, L.P. during those periods (which were prior to the acquisition of U.S. Propane, L.P., by Heritage Propane Partners, L.P.).

**Ratio of Earnings to Fixed Charges (Predecessor Heritage):**

|                                    | <u>Year Ended<br/>August 31,</u> |             | <u>Period<br/>Ended<br/>August 9,</u> |
|------------------------------------|----------------------------------|-------------|---------------------------------------|
|                                    | <u>1998</u>                      | <u>1999</u> | <u>2000</u>                           |
| Ratio of Earnings to Fixed Charges | 1.57x                            | 1.58x       | 1.35x                                 |

For these ratios, earnings is the amount resulting from adding the following items:

pre-tax income from continuing operations, before minority interest and equity in earnings of affiliates;

distributed income of equity investees; and

fixed charges.

The term fixed charges means the sum of the following:

interest expensed;

amortized debt issuance costs; and

estimated interest element of rentals.

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**Table of Contents**

**Index to Financial Statements**

**ENERGY TRANSFER TRANSACTION**

On November 7, 2003, we publicly announced the signing of definitive agreements to combine our operations with those of La Grange Energy, L.P., a company engaged in the midstream natural gas business. La Grange Energy conducts its midstream operations through its subsidiary, La Grange Acquisition, L.P., under the name Energy Transfer Company. The assets of Energy Transfer Company are primarily located in major natural gas producing regions of Texas and Oklahoma. This transaction, which we refer to as the Energy Transfer Transaction, was completed in January 2004. The Energy Transfer Transaction created a combined entity with substantially greater scale and scope of operations. We believe our larger size and our entry into the midstream natural gas business will provide us with substantial internal and external growth opportunities and reduce the seasonality associated with our propane operations.

The value of this transaction was approximately \$1.0 billion based on the average market price of our common units for the three trading days prior to and the three trading days after the time we signed the agreements related to the transaction. At the closing of this transaction in January 2004, the following transactions occurred:

La Grange Energy contributed its interest in Energy Transfer Company and certain related assets to us in exchange for the following consideration:

An amount in cash equal to \$300 million, less the amount of Energy Transfer Company debt in excess of \$151.5 million, less accounts payable and other specified liabilities of Energy Transfer Company, plus an agreed upon amount for the reimbursement of capital expenditures paid by La Grange Energy relating to the Energy Transfer Company business prior to closing;

the retirement at closing of Energy Transfer Company's then outstanding debt;

the assumption at closing of Energy Transfer Company's then existing accounts payable and other specified liabilities;

4,419,177 of our common units and 7,721,542 class D units, representing a value of approximately \$433.9 million; and

3,742,515 special units, representing a value of approximately \$133.8 million.

La Grange Energy purchased all of the partnership interests of U.S. Propane, L.P., our general partner, and all of the member interests of U.S. Propane, L.L.C., the general partner of U.S. Propane, L.P., from the current owners for \$30 million in cash. La Grange Energy is owned by Natural Gas Partners VI, L.P., a private equity fund, Ray C. Davis, Kelcy L. Warren and a group of institutional investors.

We acquired from an affiliate of the then current owners of our general partner all of the stock of Heritage Holdings, Inc., which owned approximately 4.4 million of our common units, for \$50 million in cash and a \$50 million two-year promissory note secured by a pledge of the units held by Heritage Holdings, and we inherited approximately \$104.7 million in liabilities of Heritage

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Holdings. Substantially all of these liabilities are deferred tax liabilities arising from differences in the book and tax basis of Heritage Holdings' assets. The promissory note bears interest at a rate of 7% per annum.

We completed an offering of 8.0 million common units, resulting in proceeds, before expenses, of approximately \$292.5 million.

- 32 -

**Table of Contents**

**Index to Financial Statements**

The amounts necessary to pay the cash portion of the purchase price, retire the debt of Energy Transfer Company, satisfy the accounts payable and other specified liabilities of Energy Transfer Company and fund the expenses associated with the offering completed in January 2004, a new Energy Transfer Company credit facility arranged in January 2004 and the Energy Transfer Transaction were raised from the proceeds of the January 2004 offering and borrowings under the new Energy Transfer Company credit facility. The following table sets forth an estimated breakdown of the sources and uses of the consideration to be paid in this transaction:

|  | <b>Amounts</b>       |
|--|----------------------|
|  | <b>(In Millions)</b> |
| <b>Sources of Consideration:</b>   |                      |
| Gross proceeds from the January 2004 this common unit offering                         | \$ 309.5             |
| Units issued to La Grange Energy(a)  | 567.7                |
| Note payable to acquire Heritage Holdings  | 50.0                 |
| Borrowings under new Energy Transfer Company credit facility                           | 275.0                |
| General partner cash contributions to maintain its 2% general partner interest         | 14.6                 |
|  | <u>1,216.8</u>       |
|  | <b>\$ 1,216.8</b>    |
| <b>Uses of Consideration:</b>  |                      |
| Cash payable to La Grange Energy(b)(c)   | \$ 86.8              |
| Estimated reimbursement of capital expenditures  | 5.0                  |
| Units issued to La Grange Energy(a)  | 567.7                |
| Energy Transfer Company debt, including accrued interest, retired(b)(c)                | 227.0                |
| Energy Transfer Company accounts payable and other specified liabilities assumed(b)(c) | 137.2                |
|  | <u>1,023.7</u>       |
| Energy Transfer Transaction consideration(a)   | 1,023.7              |
|  | <u>50.0</u>          |
| Cash payable to acquire Heritage Holdings  | 50.0                 |
| Note payable to acquire Heritage Holdings  | 26.5                 |
| Transaction costs, including underwriting discount                                     | 66.6                 |
| Cash on the balance sheet  | 66.6                 |
|  | <u>1,216.8</u>       |
|  | <b>\$ 1,216.8</b>    |

(a) For purposes of this table, the value attributable to the units issued to La Grange Energy is based on the average market price for our common units for the three trading days prior to and the three trading days after execution of the agreements relating to the Energy Transfer Transaction, which was \$35.74 per common unit. At the time these agreements were entered into, the parties determined the value of the units based on the prior 45 day average market price, which was \$33.40 per common unit, resulting in a value of \$987 million at such time for the Energy Transfer Transaction.

(b) Determined as of August 31, 2003.

(c) The cash payable to La Grange Energy, the Energy Transfer Company debt to be retired and the Energy Transfer Company accounts payable and other specified liabilities to be assumed will equal \$451.0 million in aggregate.

**Table of Contents**

**Index to Financial Statements**

Upon consummation of the Energy Transfer Transaction:

Energy Transfer Company became a wholly owned subsidiary of us.

There were approximately 26,722,234 common units and 7,721,542 class D units outstanding, of which 4,419,177 common units and all 7,721,542 class D units were owned by La Grange Energy. The class D units are similar to the common units and are entitled to the same cash distributions as common units, provided that the class D units' right to share in quarterly cash distributions and distributions on liquidation are subordinated to our common units' right to share in quarterly cash distributions and distributions on liquidation. The class D units will be converted into an equal number of common units following the approval by our unitholders of such conversion, and we will be obligated to seek this approval by our unitholders promptly after the closing of the Energy Transfer Transaction.

La Grange Energy also owns all 3,742,515 special units, a new class of our units that were issued in the Energy Transfer Transaction. The special units are non-voting and are not entitled to share in any partnership distributions. The special units will be converted into an equal number of common units following the occurrence of both: (1) the approval by our unitholders of such conversion and (2) the Bossier Pipeline becoming commercially operational, which we expect to occur by mid-2004. We will be obligated to seek this approval by our unitholders promptly after the closing of the Energy Transfer Transaction.

In connection with the Energy Transfer Transaction, Heritage Holdings became one of our wholly owned subsidiaries, and its 4,426,916 common units were converted into an equal number of class E units, a new class of our units. These class E units are the only outstanding class E units. These class E units are entitled to aggregate cash distributions equal to 11.1% of the total amount of cash distributed to all unitholders, including the class E unitholders, up to \$2.82 per unit per year.

There are 1,000,000 class C units outstanding. The class C units are entitled to receive any cash distributions to which the incentive distribution rights are entitled as a result of our receiving proceeds from outstanding litigation filed by us. The class C units are not entitled to any other distributions, do not generally have voting rights and are not convertible into any other class of units.

We do not include the class C units, class E units and special units in our pro forma per unit financial results included elsewhere in this prospectus. Please read "Description of Units" in this prospectus for a more complete discussion of the terms of our outstanding units.



**Table of Contents**

**Index to Financial Statements**

**ENERGY TRANSFER SELECTED HISTORICAL**

**FINANCIAL DATA**

Although Heritage Propane Partners, L.P. was the surviving parent entity for legal purposes, Energy Transfer Company was the acquiror for accounting purposes. As a result, following the Energy Transfer Transaction, the historical financial statements of Energy Transfer Company for periods prior to the closing of the transaction became our historical financial statements. Energy Transfer Company was formed on October 1, 2002 and has an August 31 year-end. Energy Transfer Company's predecessor entities had a December 31 year-end. Accordingly, Energy Transfer Company's 11-month period ended August 31, 2003 is treated as a transition period.

Energy Transfer Company's historical financial information for the period from October 1, 2002 to August 31, 2003 has been derived from the historical financial statements of Energy Transfer Company included elsewhere in this prospectus. During this time period, Energy Transfer Company owned the Southeast Texas System and the Elk City System. From October 1, 2002 through December 27, 2002, Energy Transfer Company also owned a 50% equity interest in Oasis Pipe Line Company, which owns the Oasis Pipeline. After December 27, 2002, Energy Transfer Company owned a 100% interest in Oasis Pipe Line. In addition, on December 27, 2002, an affiliate of La Grange Energy's general partner contributed to Energy Transfer its marketing business and the Vantex System, the Rusk County Gathering System, the Whiskey Bay System and the Chalkley Transmission System.

Energy Transfer Company's historical financial information for periods prior to October 1, 2002 has been derived from the historical financial statements of Aquila Gas Pipeline. Prior to October 1, 2002, Aquila Gas Pipeline owned the Southeast Texas System, the Elk City System and a 50% equity interest in Oasis Pipe Line. All of these assets were acquired by Energy Transfer Company on October 1, 2002.

The financial information below for Aquila Gas Pipeline for the nine months ended September 30, 2002 and the years ended December 31, 2001 and 2000 and as of September 30, 2002 and December 31, 2001 has been derived from the audited consolidated financial statements of Aquila Gas Pipeline included elsewhere in this prospectus. The financial information below for Aquila Gas Pipeline for the years ended December 31, 1999 and 1998 and as of December 31, 2000, 1999 and 1998 has been derived from unaudited consolidated financial statements of Aquila Gas Pipeline, which are not included in this prospectus.

The selected historical financial data should be read in conjunction with the financial statements of Energy Transfer Company and Aquila Gas Pipeline included elsewhere in this prospectus and with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus.

| <b>Aquila Gas Pipeline</b>     |             |             |             |  |   |
|--------------------------------|-------------|-------------|-------------|--|---|
| <b>Year Ended December 31,</b> |             |             |             | <b>Nine Months<br/>Ended<br/>September 30,</b> | <b>Eleven Months<br/>Ended<br/>August 31,</b> |
| <b>1998</b>                    | <b>1999</b> | <b>2000</b> | <b>2001</b> |  |   |
|                                |             |             |             |  |   |

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|   | (Unaudited) |              | (In thousands) |              | 2002       | 2003(a)       |
|---|-------------|--------------|----------------|--------------|------------|---------------|
| <b>Statement of Operations Data:</b>          |             |              |                |              |            |               |
| Revenues                                      |             |              |                |              |            |               |
| Midstream segment                             | \$ 902,045  | \$ 1,030,554 | \$ 1,758,530   | \$ 1,813,850 | \$ 933,099 | \$ 978,106(b) |
| Transportation segment                        |             |              |                |              |            | 30,617        |
| Total revenues                                | 902,045     | 1,030,554    | 1,758,530      | 1,813,850    | 933,099    | 1,008,723     |
| Gross profit                                  | 80,631      | 94,109       | 117,663        | 98,589       | 53,035     | 109,184       |
| Depreciation and amortization                 | 26,417      | 27,061       | 30,049         | 30,779       | 22,915     | 13,461        |
| Operating income                              | 16,596      | 30,795       | 31,024         | 42,990       | 2,862      | 61,589        |
| Interest expense                              | 14,125      | 12,894       | 12,098         | 6,858        | 3,931      | 12,057        |
| Income before income taxes                    | 3,711       | 17,502       | 18,892         | 41,161       | 4,272      | 51,057        |
| Provision for income taxes                    | (1,157)     | 5,913        | 7,657          | 15,403       | (467)      | 4,432(c)      |
| Net income                                    | 4,868       | 11,589       | 11,235         | 25,758       | 4,739      | 46,625        |
| <b>Balance Sheet Data (at period end):</b>    |             |              |                |              |            |               |
| Current assets                                | 109,286     | 108,552      | 231,260        | 144,396      | 116,831    | 183,770(d)    |
| Total assets                                  | 632,112     | 620,920      | 724,161        | 633,260      | 601,528    | 600,693       |
| Current liabilities                           | 133,299     | 160,419      | 313,506        | 194,816      | 144,076    | 168,063       |
| Long-term debt, including current maturities  | 197,450     | 163,273      | 110,721        | 78,750       | 66,250     | 226,000       |
| Stockholders' equity/Partners' equity         | 226,755     | 237,877      | 254,248        | 249,520      | 254,259    | 181,088       |
| <b>Other Financial Data:</b>                  |             |              |                |              |            |               |
| Cash flow from operating activities           | 45,709      | 43,182       | 76,011         | 65,198       | 12,987     | 70,916        |
| Cash flow used in investing activities        | (20,755)    | (13,785)     | (23,459)       | (20,727)     | (487)      | (341,177)     |
| Cash flow from (used in) financing activities | (28,109)    | (34,544)     | (52,552)       | (44,471)     | (12,500)   | 323,383       |

- (a) On December 27, 2002, Energy Transfer Company purchased the remaining 50% of Oasis Pipe Line. Prior to December 27, 2002, the interest in Oasis Pipe Line was treated as an equity method investment. After this date, Oasis Pipe Line's results of operations are consolidated with Energy Transfer Company as a wholly-owned subsidiary.
- (b) For purposes of this presentation, the elimination of intersegment revenues of \$10.5 million has been classified as a reduction of the midstream segment's revenues for the 11 months ended August 31, 2003.
- (c) As a partnership, Energy Transfer is not subject to income taxes. However, its subsidiary, Oasis Pipe Line, is a corporation that is subject to income taxes at an effective rate of 35%. As a result, all income tax expense for Energy Transfer for the 11 months ended August 31, 2003 is directly related to Oasis Pipe Line. Prior to 2003, Oasis Pipe Line was an equity method investment of Energy Transfer, and taxes were netted against the equity method earnings. Aquila Gas Pipeline was a tax paying corporation, and as such recognized income taxes related to its earnings in all periods presented.
- (d) Prior to the closing of the Energy Transfer Transaction, Energy Transfer Company will distribute its cash and cash equivalents and accounts receivable to La Grange Energy. Cash and cash equivalents and accounts receivable were \$159.1 million as of August 31, 2003.

**Table of Contents****Index to Financial Statements****HERITAGE PROPANE PARTNERS SELECTED HISTORICAL****FINANCIAL AND OPERATING DATA**

The following table sets forth, for the periods and as of the dates indicated, selected historical financial and operating data for Heritage Propane Partners, L.P. and its subsidiaries. Information presented represents financial and operating data prior to and following the transactions with U.S. Propane and Peoples Gas that occurred in August 2000 and is described in detail in our Annual Report on Form 10-K for the fiscal year ended August 31, 2003. Although Heritage Propane Partners was the surviving entity for legal purposes in this transaction, Peoples Gas was the acquiror for accounting purposes. The years ended December 31, 1998 and 1999, and the eight-month period ended August 31, 1999 reflect the results of Peoples Gas on a stand-alone basis. The eight-month period ended August 31, 2000 was treated as a transition period, and represents seven months of Peoples Gas stand-alone and one month of Heritage Propane Partners. The years ended August 31, 2001, 2002 and 2003 reflect the results of Heritage Propane Partners following the transactions with U.S. Propane. This selected historical financial and operating data should be read in conjunction with the financial statements of Heritage Propane Partners, L.P. included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2003, which is incorporated by reference in this prospectus, and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus.

|  | Years Ended  |           | Eight Months     |           | Years Ended August 31,                  |            |            |
|--|--------------|-----------|------------------|-----------|---|------------|------------|
|  | December 31, |           | Ended August 31, |           | 2001                                    | 2002       | 2003       |
|  | 1998         | 1999      | 1999             | 2000      |   |            |            |
|  | (Unaudited)  |           |                  |           | (In thousands, except per unit amounts) |            |            |
| <b>Statements of Operating Data:</b>                     |              |           |                  |           |   |            |            |
| Revenues   | \$ 30,187    | \$ 34,045 | \$ 21,766        | \$ 51,534 | \$ 543,975                              | \$ 462,325 | \$ 571,476 |
| Gross profit(a)  | 17,904       | 19,196    | 13,299           | 21,572    | 237,419                                 | 224,140    | 274,320    |
| Depreciation and amortization                            | 2,855        | 3,088     | 2,037            | 4,686     | 40,431                                  | 36,998     | 37,959     |
| Operating income (loss)                                  | 3,961        | 2,885     | 2,666            | (714)     | 54,423                                  | 40,961     | 70,193     |
| Interest expense   |              |           |                  | 2,409     | 35,567                                  | 37,341     | 35,740     |
| Income (loss) before income taxes and minority interests | 3,483        | 2,895     | 2,677            | (3,547)   | 20,524                                  | 5,476      | 33,041     |
| Provision for income taxes                               | 1,412        | 1,127     | 1,035            | 379       |   |            | 1,023      |
| Net income (loss)  | 2,071        | 1,768     | 1,642            | (3,846)   | 19,710                                  | 4,902      | 31,142     |
| Basic net income (loss) per unit(b)                      | 1.19         | 1.02      | 0.94             | (0.37)    | 1.43                                    | 0.25       | 1.79       |
| Cash dividends/distributions per unit                    | 1.13         | 1.30      | 1.30             | 0.87      | 2.38                                    | 2.55       | 2.60       |
| <b>Balance Sheet Data (at period end):</b>               |              |           |                  |           |   |            |            |
| Current assets   | \$ 4,310     | \$ 6,643  | \$ 4,326         | \$ 84,869 | \$ 138,263                              | \$ 95,387  | \$ 94,138  |
| Total assets   | 37,206       | 43,724    | 39,481           | 615,779   | 758,167                                 | 717,264    | 738,839    |
| Current liabilities                                      | 13,671       | 19,636    | 15,716           | 102,212   | 127,655                                 | 122,069    | 151,027    |
| Long-term debt   |              | 525       |                  | 361,990   | 423,748                                 | 420,021    | 360,762    |
| Minority interests                                       |              |           |                  | 4,821     | 5,350                                   | 3,564      | 4,002      |
| Total partners' capital                                  | 15,596       | 15,107    | 14,981           | 146,756   | 201,414                                 | 171,610    | 223,048    |
| <b>Other Financial and Operating Data (unaudited):</b>   |              |           |                  |           |   |            |            |
| EBITDA, as adjusted(c)                                   | \$ 6,816     | \$ 5,973  | \$ 4,703         | \$ 4,507  | \$ 97,444                               | \$ 81,536  | \$ 110,963 |

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|  |         |         |           |           |          |          |
|--|---------|---------|-----------|-----------|----------|----------|
| Cash flows from operating activities           | 9,219   | 9,353   | 14,508    | 28,056    | 65,453   | 95,199   |
| Cash flows used in investing activities        | (7,047) | (7,191) | (183,037) | (122,313) | (33,412) | (48,389) |
| Cash flows from (used in) financing activities | (2,317) | (2,257) | 173,353   | 95,038    | (33,071) | (44,289) |
| Capital expenditures(d)                        |         |         |           |           |          |          |
| Maintenance                                    | 5,328   | 6,176   | 2,544     | 3,559     | 8,504    | 15,136   |
| Growth and acquisition                         | 1,719   | 1,015   | 1,015     | 177,067   | 110,210  | 37,114   |
| Retail gallons sold                            | 30,921  | 33,608  | 22,118    | 38,268    | 330,242  | 375,939  |

- (a) Gross profit is computed by reducing total revenues by the direct cost of the products sold.
- (b) Net income per unit is computed by dividing the limited partner's interest in net income by the weighted average number of units outstanding.
- (c) EBITDA, as adjusted is defined as our earnings before interest, taxes, depreciation, amortization and other non-cash items, such as compensation charges for unit issuances to employees, gain or loss on

- 36 -

**Table of Contents**

**Index to Financial Statements**

disposal of assets, and other expenses. We present EBITDA, as adjusted, on a partnership basis which includes both the general and limited partner interests. Non-cash compensation expense represents charges for the value of the common units awarded under our compensation plans that have not yet vested under the terms of those plans and are charges which do not, or will not, require cash settlement. Non-cash income such as the gain arising from our disposal of assets is not included when determining EBITDA, as adjusted. EBITDA, as adjusted (i) is not a measure of performance calculated in accordance with GAAP and (ii) should not be considered in isolation or as a substitute for net income, income from operations or cash flow as reflected in our consolidated financial statements.

EBITDA, as adjusted is presented because such information is relevant and is used by management, industry analysts, investors, lenders and rating agencies to assess the financial performance and operating results of our fundamental business activities. Management believes that the presentation of EBITDA, as adjusted is useful to lenders and investors because of its use in the propane industry and for master limited partnerships as an indicator of the strength and performance of our ongoing business operations, including the ability to fund capital expenditures, service debt and pay distributions. Additionally, management believes that EBITDA, as adjusted provides additional and useful information to our investors for trending, analyzing and benchmarking our operating results from period to period as compared to other companies that may have different financing and capital structures. The presentation of EBITDA, as adjusted allows investors to view our performance in a manner similar to the methods used by management and provides additional insight to our operating results.

EBITDA, as adjusted is used by management to determine our operating performance, and along with other data as internal measures for setting annual operating budgets, assessing financial performance of our numerous business locations, as a measure for evaluating targeted businesses for acquisition and as a measurement component of incentive compensation. We have a large number of business locations located in different regions of the United States. EBITDA, as adjusted can be a meaningful measure of financial performance because it excludes factors which are outside the control of the employees responsible for operating and managing the business locations, and provides information management can use to evaluate the performance of the business locations, or the region where they are located, and the employees responsible for operating them. To present EBITDA, as adjusted on a full partnership basis, we add back the minority interest of the general partner because net income is reported net of the general partner's minority interest. Our EBITDA, as adjusted includes non-cash compensation expense which is a non-cash expense item resulting from our unit based compensation plans that does not require cash settlement and is not considered during management's assessment of the operating results of our business. Adding these non-cash compensation expenses in EBITDA, as adjusted allows management to compare our operating results to those of other companies in the same industry who may have compensation plans with levels and values of annual grants that are different than us. Other expenses include other finance charges and other asset non-cash impairment charges that are reflected in our operating results but are not classified in interest, depreciation and amortization. We do not include gain on the sale of assets when determining EBITDA, as adjusted since including non-cash income resulting from the sale of assets increases the performance measure in a manner that is not related to the true operating results of our business. In addition, our debt agreements contain financial covenants based on EBITDA, as adjusted. For a description of these covenants, please read Management's Discussion and Analysis of Financial Condition and Results of Operations Description of Indebtedness.

**Table of Contents**

**Index to Financial Statements**

There are material limitations to using a measure such as EBITDA, as adjusted, including the difficulty associated with using it as the sole measure to compare the results of one company to another, and the inability to analyze certain significant items that directly affect a company's net income or loss. In addition, our calculation of EBITDA, as adjusted may not be consistent with similarly titled measures of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP. EBITDA, as adjusted for the periods described herein is calculated in the same manner as presented by us in the past. Management compensates for these limitations by considering EBITDA, as adjusted in conjunction with its analysis of other GAAP financial measures, such as gross profit, net income (loss), and cash flow from operating activities. A reconciliation of EBITDA, as adjusted to net income (loss) is presented below. Please read [Reconciliation of EBITDA, As Adjusted to Net Income](#) below.

**Table of Contents****Index to Financial Statements****Reconciliation of EBITDA, As Adjusted, to Net Income**

The following tables set forth the reconciliation of EBITDA, as adjusted, to our net income for the periods indicated:

|  | Years Ended<br>December 31, |                 | Eight Months Ended<br>August 31, |                 | Years Ended August 31, |                  |                   |
|--|-----------------------------|-----------------|----------------------------------|-----------------|------------------------|------------------|-------------------|
|  | 1998                        | 1999            | 1999                             | 2000            | 2001                   | 2002             | 2003              |
| (In thousands)   |                             |                 |                                  |                 |                        |                  |                   |
| <b>Net income reconciliation</b>                               |                             |                 |                                  |                 |                        |                  |                   |
| Net income (loss)  | \$ 2,071                    | \$ 1,768        | \$ 1,642                         | \$ (3,846)      | \$ 19,710              | \$ 4,902         | \$ 31,142         |
| Depreciation and amortization                                  | 2,855                       | 3,088           | 2,037                            | 4,686           | 40,431                 | 36,998           | 37,959            |
| Interest   |                             |                 |                                  | 2,409           | 35,567                 | 37,341           | 35,740            |
| Taxes  | 1,412                       | 1,127           | 1,035                            | 379             |                        |                  | 1,023             |
| Non-cash compensation expense                                  |                             |                 |                                  | 549             | 1,079                  | 1,878            | 1,159             |
| Other expenses   | 478                         | (10)            | (11)                             | 478             | 394                    | 294              | 3,213             |
| Depreciation, amortization, and interest and taxes of investee |                             |                 |                                  | 73              | 792                    | 743              | 901               |
| Minority interest in the Operating Partnership                 |                             |                 |                                  | (100)           | 283                    | 192              | 256               |
| Less: Gain on disposal of assets                               |                             |                 |                                  | (121)           | (812)                  | (812)            | (430)             |
| <b>EBITDA, as adjusted</b>                                     | <b>\$ 6,816</b>             | <b>\$ 5,973</b> | <b>\$ 4,703</b>                  | <b>\$ 4,507</b> | <b>\$ 97,444</b>       | <b>\$ 81,536</b> | <b>\$ 110,963</b> |

- (d) Capital expenditures fall generally into three categories: (1) maintenance capital expenditures, which include expenditures for repairs that extend the life of the assets and replacement of property, plant and equipment, (2) growth capital expenditures, which include expenditures for purchase of new propane tanks and other equipment to facilitate retail customer base expansion, and (3) acquisition expenditures which include expenditures related to the acquisition of retail propane operations and other business, and the portion of the purchase price allocated to intangibles associated with such acquired businesses.

**Table of Contents****Index to Financial Statements****HERITAGE PROPANE PARTNERS PRO FORMA FINANCIAL DATA**

The following unaudited pro forma financial data reflects the historical results of Heritage Propane Partners, L.P. as adjusted on a pro forma basis to give effect to the consummation of the Energy Transfer Transaction, the borrowing under the new Energy Transfer Company credit facility arranged in January 2004 and described in Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, and the offering completed in January 2004 and the use of proceeds from the borrowing and that offering as if these transactions occurred on September 1, 2002 for income statement purposes and August 31, 2003 for balance sheet purposes. Although Heritage Propane Partners, L.P. will be the surviving parent entity for legal purposes, Energy Transfer Company will be the acquiror for accounting purposes. As a result, following the closing of the Energy Transfer Transaction, the historical financial statements of Energy Transfer Company for periods prior to the closing became our historical financial statements. For a discussion of the assumptions and specific adjustments used in preparing the pro forma financial data, please read the pro forma financial statements included elsewhere in this prospectus.

|   | <b>Twelve Months<br/>Ended<br/>August 31, 2003</b> |
|---|--|
|   | <b>(In thousands, except<br/>per unit amounts)</b> |
| <b>Statement of Operations Data:</b>              |  |
| Revenues  | \$ 1,714,440                                       |
| Costs and expenses:                               |  |
| Costs of products sold                            | 1,309,497  |
| Operating expenses                                | 175,301  |
| Depreciation and amortization                     | 56,245   |
| Selling, general and administrative               | 31,789   |
|   | <hr/>  |
| Total costs and expenses                          | 1,572,832  |
|   | <hr/>  |
| Operating income                                  | 141,608  |
| Other income (expense):                           |  |
| Interest expense                                  | (54,070)   |
| Equity in earnings of affiliates                  | 1,120  |
| Gain on disposal of assets                        | 273  |
| Other   | (2,912)  |
|   | <hr/>  |
| Income before minority interests and income taxes | 86,019   |
| Minority interests                                | 558  |
|   | <hr/>  |
| Income before income taxes                        | 85,461   |
| Income taxes                                      | 10,924   |
|   | <hr/>  |
| Net income  | 74,537   |
| General partner's interest in net income          | 1,491  |
|   | <hr/>  |
| Limited partners' interest in net income          | \$ 73,046  |
|   | <hr/>  |
| Net income per unit                               | \$ 2.24  |



**Balance Sheet Data (at end of period):**

|   |    |           |
|---|----|-----------|
| Cash and cash equivalents               | \$ | 72,091    |
| Working capital                         |    | 36,252    |
| Property, plant and equipment (net)     |    | 861,604   |
| Total assets                            |    | 1,428,948 |
| Long term debt, less current maturities |    | 685,762   |
| Partners' capital                       |    | 429,925   |

**Other Financial Data:**

|                        |    |         |
|------------------------|----|---------|
| EBITDA, as adjusted(a) | \$ | 200,475 |
|------------------------|----|---------|

- (a) EBITDA, as adjusted is defined as our earnings before interest, taxes, depreciation, amortization and other non-cash items, such as compensation charges for unit issuances to employees, gain or loss on disposal of assets, and other expenses. We present EBITDA, as adjusted, on a partnership basis which includes both the general and limited partner interests. Non-cash compensation expense represents charges for the value of the common units awarded under our compensation plans that have not yet vested under the terms of those plans and are charges which do not, or will not, require cash settlement. Non-cash income such as the gain arising from our disposal of assets is not included when determining EBITDA, as adjusted. EBITDA, as adjusted (i) is not a measure of performance calculated in accordance with generally accepted accounting principles, or GAAP, and (ii) should not be considered in isolation or as a substitute for net income, income from operations or cash flow as reflected in our consolidated financial statements.

**Table of Contents**

**Index to Financial Statements**

EBITDA, as adjusted is presented because such information is relevant and is used by management, industry analysts, investors, lenders and rating agencies to assess the financial performance and operating results of our fundamental business activities. Management believes that the presentation of EBITDA, as adjusted is useful to lenders and investors because of its use in the propane and midstream natural gas industries and for master limited partnerships as an indicator of the strength and performance of our ongoing business operations, including the ability to fund capital expenditures, service debt and pay distributions. Additionally, management believes that EBITDA, as adjusted provides additional and useful information to our investors for trending, analyzing and benchmarking our operating results from period to period as compared to other companies that may have different financing and capital structures. The presentation of EBITDA, as adjusted allows investors to view our performance in a manner similar to the methods used by management and provides additional insight to our operating results.

EBITDA, as adjusted is used by management to determine our operating performance, and along with other data as internal measures for setting annual operating budgets, assessing financial performance of our numerous business locations, as a measure for evaluating targeted businesses for acquisition and as a measurement component of incentive compensation. We have a large number of business locations located in different regions of the United States. EBITDA, as adjusted can be a meaningful measure of financial performance because it excludes factors which are outside the control of the employees responsible for operating and managing the business locations, and provides information management can use to evaluate the performance of the business locations, or the region where they are located, and the employees responsible for operating them. To present EBITDA, as adjusted on a full partnership basis, we add back the minority interest of the general partner because net income is reported net of the general partner's minority interest. Our EBITDA, as adjusted includes non-cash compensation expense which is a non-cash expense item resulting from our unit based compensation plans that does not require cash settlement and is not considered during management's assessment of the operating results of our business. Adding these non-cash compensation expenses in EBITDA, as adjusted allows management to compare our operating results to those of other companies in the same industry who may have compensation plans with levels and values of annual grants that are different than us. Other expenses include other finance charges and other asset non-cash impairment charges that are reflected in our operating results but are not classified in interest, depreciation and amortization. We do not include gain

**Table of Contents**

**Index to Financial Statements**

on the sale of assets when determining EBITDA, as adjusted since including non-cash income resulting from the sale of assets increases the performance measure in a manner that is not related to the true operating results of our business. In addition, our debt agreements contain financial covenants based on EBITDA, as adjusted. For a description of these covenants, please read Management's Discussion and Analysis of Financial Condition and Results of Operations Description of Indebtedness.

There are material limitations to using a measure such as EBITDA, as adjusted, including the difficulty associated with using it as the sole measure to compare the results of one company to another, and the inability to analyze certain significant items that directly affect a company's net income or loss. In addition, our calculation of EBITDA, as adjusted may not be consistent with similarly titled measures of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP. EBITDA, as adjusted for the periods described herein is calculated in the same manner as presented by us in the past. Management compensates for these limitations by considering EBITDA, as adjusted in conjunction with its analysis of other GAAP financial measures, such as gross profit, net income (loss), and cash flow from operating activities. A reconciliation of EBITDA, as adjusted to net income (loss) is presented below. Please read Reconciliation of EBITDA, As Adjusted, to Pro Forma Net Income below.

**Table of Contents**

**Index to Financial Statements**

**Reconciliation of Pro Forma EBITDA, As Adjusted, to Pro Forma Net Income**

The following table sets forth the reconciliation of pro forma EBITDA, as adjusted, to our pro forma net income for the twelve months ended August 31, 2003:

|  | <b>Twelve Months Ended<br/>August 31, 2003</b> |
|--|--|
|  | <b>(In thousands)</b>                          |
| Net income   | \$ 74,537                                      |
| Depreciation and amortization                                  | 56,245   |
| Interest   | 54,070   |
| Taxes  | 10,924   |
| Non-cash compensation expense                                  | 1,159  |
| Other expenses   | 2,912  |
| Depreciation, amortization, and interest and taxes of investee | 901  |
| Less: Gain on disposal of assets                               | (273)  |
|  | <hr/>  |
| EBITDA, as adjusted  | \$ 200,475                                     |
|  | <hr/>  |

**Table of Contents**

**Index to Financial Statements**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following discussion of our financial condition and results of operations in conjunction with the historical and pro forma combined financial statements and notes thereto included elsewhere in this prospectus supplement. For more detailed information regarding the basis of presentation for the following information, you should read the notes to the historical and pro forma financial statements included in this prospectus supplement.*

**Overview**

We are a publicly traded Delaware limited partnership formed in conjunction with our initial public offering as Heritage Propane Partners, L.P. in June 1996. We are engaged in the natural gas midstream business through our operating subsidiary, La Grange Acquisition, L.P., and in the retail propane marketing business through our operating subsidiary, Heritage Operating, L.P. Following the completion of our transaction in January 2004, in which we combined the retail propane operations of Heritage Propane Partners with the natural gas midstream operations of Energy Transfer Company, we changed our name to Energy Transfer Partners, L.P. In the following discussion, references to Heritage Propane or Heritage Propane Partners refer to Heritage Propane Partners, L.P. and its subsidiaries and their business and operations prior to the completion of the Energy Transfer Transaction, and references to Energy Transfer or Energy Transfer Company refer to LaGrange Acquisition, L.P. and its subsidiaries and their business and operations conducted under the name Energy Transfer Company prior to the completion of the Energy Transfer Transaction.

***Heritage Propane Partners***

We are one of the largest retail propane marketers in the United States, serving more than 650,000 customers from over 300 customer service locations in 31 states. Our operations extend from coast to coast, with concentrations in the western, upper midwestern, northeastern and southeastern regions of the United States. We are also a wholesale propane supplier in the southwestern and southeastern United States and in Canada, the latter through participation in M-P Energy Partnership. M-P Energy Partnership is a Canadian partnership in which we own a 60% interest, engaged in wholesale distribution and in supplying our northern U.S. locations. We are a publicly traded Delaware limited partnership formed in conjunction with our initial public offering in June of 1996. Our business has grown primarily through acquisitions of retail propane operations and, to a lesser extent, through internal growth. Since our inception through August 31, 2003, we have completed 97 acquisitions for an aggregate purchase price of approximately \$675 million. Volumes of propane sold to retail customers have increased steadily from 63.2 million gallons for the fiscal year ended August 31, 1992 to 375.9 million gallons for the fiscal year ended August 31, 2003.

The retail propane business is a margin-based business in which gross profits depend on the excess of sales price over propane supply costs. The market price of propane is often subject to volatile changes as a result of supply or other market conditions over which we will have no control. Product supply contracts are typically one-year agreements subject to annual renewal and generally provide for pricing in accordance with posted prices at the time of delivery or the current market prices established at major delivery or storage points. In addition, some contracts include a pricing formula that typically is based on these market prices. Most of these agreements provide maximum and minimum seasonal purchase guidelines. The number of contracts entered into may vary from year to year. Since rapid increases in the wholesale cost of propane may not be immediately passed on to retail customers, such increases could reduce gross profits. We generally have attempted to reduce



**Table of Contents**

**Index to Financial Statements**

price risk by purchasing propane on a short-term basis. We have on occasion purchased significant volumes of propane during periods of low demand, which generally occur during the summer months, at the then current market price, for storage both at our customer service locations and in major storage facilities for future resale.

Our retail propane business consists principally of transporting propane purchased in the contract and spot markets, primarily from major fuel suppliers, to our customer service locations and then to tanks located on the customers' premises, as well as to portable propane cylinders. In the residential and commercial markets, propane is primarily used for space heating, water heating and cooking. In the agricultural market, propane is primarily used for crop drying, tobacco curing, poultry brooding and weed control. In addition, propane is used for certain industrial applications, including use as an engine fuel for internal combustion engines that power vehicles and forklifts and as a heating source in manufacturing and mining processes.

Our propane distribution business is largely seasonal and dependent upon weather conditions in our service areas. Propane sales to residential and commercial customers are affected by winter heating season requirements. Historically, approximately two-thirds of our retail propane volume and in excess of 80% of our EBITDA is attributable to sales during the six-month peak-heating season of October through March. This generally results in higher operating revenues and net income during the period from October through March of each year and lower operating revenues, and in some cases, net losses or lower net income during the period from April through September of each year. Consequently, sales and operating profits are concentrated in the first and second fiscal quarters, while cash flow from operations is generally greatest during the second and third fiscal quarters when customers pay for propane purchased during the six-month peak-heating season. Sales to industrial and agricultural customers are much less weather sensitive.

A substantial portion of our propane is used in the heating-sensitive residential and commercial markets resulting in the temperatures realized in our areas of operations, particularly during the six-month peak-heating season, having a significant effect on our financial performance. In any given area, sustained warmer-than-normal temperatures will tend to result in reduced propane use, while sustained colder-than-normal temperatures will tend to result in greater propane use. We use information based on normal temperatures in understanding how temperatures that are colder or warmer than normal affect historical results of operations and in preparing forecasts of future operations.

Gross profit margins are not only affected by weather patterns, but also vary according to customer mix. For example, sales to residential customers generate higher margins than sales to certain other customer groups, such as commercial or agricultural customers. Wholesale margins are substantially lower than retail margins. In addition, gross profit margins vary by geographical region. Accordingly, a change in customer or geographic mix can affect gross profit without necessarily affecting total revenues.

***The Energy Transfer Transaction***

On November 7, 2003, we publicly announced the signing of definitive agreements to combine our operations with those of La Grange Energy, which is engaged in the midstream natural gas business. La Grange Energy conducts its midstream operations through La Grange Acquisition, whose midstream operations are conducted under the name Energy Transfer Company. La Grange Energy is owned by Natural Gas Partners VI, L.P., a private equity fund, Ray C. Davis, Kelcy L. Warren and a group of institutional investors.

**Table of Contents**

**Index to Financial Statements**

In connection with the transaction, La Grange Energy contributed interests in Energy Transfer and certain related assets to us in exchange for:

\$300 million in cash, subject to certain adjustments including (1) a reduction for any accounts payable and other specified liabilities of Energy Transfer at closing, (2) a reduction to the extent that the long-term debt of Energy Transfer at closing is greater than \$151.5 million, (3) an increase to the extent that the long-term debt of Energy Transfer at closing is less than \$151.5 million and (4) an increase by up to \$80 million to reimburse La Grange Energy for certain mutually agreed upon capital expenditures paid by La Grange Energy to third parties prior to the closing, and

the retirement at closing of Energy Transfer's debt;

the assumption at closing of Energy Transfer's accounts payable and other specified liabilities;

15,883,234 units, comprising limited partner interests in us. The units are comprised of the following:

4,419,177 common units;

7,721,542 class D units; and

3,742,515 special units.

Please read "Description of Units - Class D Units" and "Special Units" for a more detailed description of our class D units and special units.

In conjunction with this transaction, Energy Transfer distributed its cash and accounts receivable to La Grange Energy, and an affiliate of La Grange Energy contributed an office building to Energy Transfer, in each case prior to the contribution of Energy Transfer Company to us.

The amounts necessary to pay the cash portion of the purchase price, retire outstanding indebtedness under the credit facilities of Energy Transfer Company, satisfy Energy Transfer Company's accounts payable and other specified liabilities and to fund the expenses associated with the Energy Transfer Transaction were raised from the proceeds of a public offering of common units completed in January 2004 and borrowings under the new Energy Transfer Company credit facility.

Please read "Liquidity and Capital Resources - Financing and Sources of Liquidity - Energy Transfer Facilities."

As a part of the above transaction, La Grange Energy purchased all of the partnership interests of U.S. Propane, L.P., our general partner, and all of the member interests of U.S. Propane, L.L.C., the general partner of U.S. Propane, L.P. (which are collectively referred to as our "general partner"), from subsidiaries of AGL Resources, Inc., Atmos Energy Corporation, TECO Energy, Inc. and Piedmont Natural Gas Company, Inc.



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(the Previous Owners ) for \$30 million in cash. Prior to the sale of our general partner to La Grange Energy, certain assets of our general partner, including all of the stock of Heritage Holdings and 180,028 common units, were distributed by our general partner to an affiliate of the Previous Owners. At the time of this transaction, U.S. Propane, L.P. owned a 1% general partner interest in us and a 1.01% general partner interest in our

- 46 -

**Table of Contents**

**Index to Financial Statements**

operating partnership, Heritage Operating, L.P. As part of the acquisition of our general partner, U.S. Propane, L.P. made a capital contribution of its interest in the operating partnership to us in exchange for an additional 1% general partner interest in us, such that following the capital contribution, U.S. Propane, L.P. became the owner of a 2% general partner interest in us.

Also in conjunction with these transactions, we acquired from this affiliate of the Previous Owners all of the stock of Heritage Holdings, which owned approximately 4,426,916 common units, for \$100 million in cash. In addition, we inherited approximately \$104.7 million in liabilities of Heritage Holdings. Substantially all of these liabilities are deferred tax liabilities arising from differences in the book and tax basis of Heritage Holdings' assets. After our purchase of Heritage Holdings, the common units owned by Heritage Holdings were converted into class E units. Please read "Description of Units" for a description of the class E units.

In connection with these transactions, La Grange Energy and its affiliates, including Ray C. Davis and Kelcy L. Warren, agreed not to engage, invest or participate, directly or indirectly, in any business activities involving (a) the purchase, sale, exchange, marketing, trading, storage or transportation of propane or (b) the purchase, gathering, treating, processing, marketing, sales, storage, transportation, fractionation or distribution of natural gas and NGLs, subject to certain limited exceptions. Each of La Grange Energy and its affiliates agreed not to engage in these activities until the earlier of (i) the third anniversary of the closing of the Energy Transfer Transaction or (ii) the date such party ceases to be engaged in the business of Heritage or the business of Energy Transfer as an owner, officer, director or employee, as the case may be.

Also in connection with the transactions, the Previous Owners agreed not to engage, invest or participate, directly or indirectly, in any business activities involving the purchase, sale, exchange, marketing, trading, storage or transportation of propane, subject to certain limited exceptions, until the third anniversary of the closing of the Energy Transfer Transaction.

We have previously entered into employment agreements with our executive officers, H. Michael Krimbill, R.C. Mills, Michael L. Greenwood, Bradley K. Atkinson, Mark A. Darr, Thomas H. Rose and Curtis L. Weishahn. The consummation of the Energy Transfer Transaction constituted a "change of control" under these employment agreements. As a result, upon the consummation of the Energy Transfer Transaction, we were obligated to make a cash payment to each of our executive officers in an amount equal to their base salary and were also required to make a bonus payment in common units to each of our executive officers. The aggregate cash payment was approximately \$1.6 million and that the aggregate bonus payment was 150,018 common units. Each employment agreement also provides that if any payment received by the executive officer is subject to the 20% federal excise tax under Section 4999(a) of the Internal Revenue Code, the payment will be grossed up to permit the executive officer to retain a net amount on an after-tax basis equal to what he would have received had the excise tax and all other federal and state taxes on such additional amount not been payable. In addition, pursuant to the terms of the employment agreement of Michael L. Greenwood, 20,000 common units to which he is entitled were awarded.

The consummation of the Energy Transfer Transaction also constituted a "change of control" under our Second Amended and Restated Restricted Unit Plan. As a result, all rights to acquire common units pursuant to the Restricted Unit Plan became vested. As of December 31, 2003, unvested rights to acquire 26,100 common units were outstanding under the Restricted Unit Plan. Of these unvested rights, rights to acquire 4,500 common units were held by non-employee directors and rights to acquire 21,600 common units were held by employees that are not executive officers.

Each of these employment agreements and the Restricted Unit Plan is described in more detail in our Annual Report on Form 10-K for the fiscal year ended August 31, 2003.



**Table of Contents**

**Index to Financial Statements**

***Energy Transfer***

Energy Transfer is a Texas limited partnership formed in September 2002 to own, operate and acquire midstream assets from Aquila Gas Pipeline, an affiliate of Aquila, Inc. Energy Transfer's operations are concentrated in the Austin Chalk trend of southeast Texas, the Anadarko Basin of western Oklahoma and the Permian Basin of west Texas. It divides its operations into the following two business segments:

*Midstream Segment*, which focuses on the gathering, compression, treating, processing and marketing of natural gas, primarily in the Southeast Texas System and the Elk City System. For the 11 months ended August 31, 2003, approximately 72% of Energy Transfer's gross margin was derived from this segment.

*Transportation Segment*, which focuses on the transportation of natural gas through the Oasis Pipeline. For the 11 months ended August 31, 2003, approximately 28% of Energy Transfer's gross margin was derived from this segment.

During the 11 months ended August 31, 2003, Energy Transfer generated approximately 46% of its gross margin from fees it charged for providing its services, including a transportation fee it charges the producer services business for natural gas that the producer service business transports on the Oasis Pipeline equal to the fee it charges third parties. This transportation fee accounted for 7% of its total gross margin for this period. Energy Transfer generated the remaining 54% of its gross margin from discount-to-index, percentage-of-proceeds and keep-whole arrangements and from its producer services business. We intend to seek to increase the percentage of Energy Transfer's business conducted under fee-based arrangements in order to reduce our exposure to increases and decreases in the price of natural gas and NGLs. However, in order to remain competitive, Energy Transfer will need to offer other contractual arrangements to attract certain natural gas supplies to its systems.

***The Midstream Segment***

Results from the Midstream segment are determined primarily by the volumes of natural gas gathered, compressed, treated, processed, purchased and sold through Energy Transfer's pipeline and gathering systems and the level of natural gas and NGL prices. Energy Transfer generates its revenues and its gross margins principally under the following types of arrangements:

*Fee-based arrangements.* Under fee-based arrangements, Energy Transfer receives a fee or fees for one or more of the following services: gathering, compressing, treating or processing natural gas. The revenue it earns from these arrangements is directly related to the volume of natural gas that flows through its systems and is not directly dependent on commodity prices. To the extent a sustained decline in commodity prices results in a decline in volumes, however, its revenues from these arrangements would be reduced.

*Other arrangements.* Energy Transfer also utilizes other types of arrangements in its Midstream segment, including:

*Discount-to-index price arrangements.* Under discount-to-index price arrangements, Energy Transfer generally purchases natural gas at either (1) a percentage discount to a specified index price, (2) a specified index price less a fixed amount or (3) a percentage discount to a specified index price less an



**Table of Contents**

**Index to Financial Statements**

additional fixed amount. It then gathers and delivers the natural gas to pipelines where it resells the natural gas at the index price. The gross margins Energy Transfer realizes under the arrangements described in clauses (1) and (3) above decrease in periods of low natural gas prices because these gross margins are based on a percentage of the index price.

*Percentage-of-proceeds arrangements.* Under percentage-of-proceeds arrangements, Energy Transfer generally gathers and processes natural gas on behalf of producers, sells the resulting residue gas and NGL volumes at market prices and remits to producers an agreed upon percentage of the proceeds based on an index price. In other cases, instead of remitting cash payments to the producer, Energy Transfer delivers an agreed upon percentage of the residue gas and NGL volumes to the producer and sells the volumes it keeps to third parties at market prices. Under these types of arrangements, Energy Transfer's revenues and gross margins increase as natural gas prices and NGL prices increase, and its revenues and gross margins decrease as natural gas prices and NGL prices decrease.

*Keep-whole arrangements.* Under keep-whole arrangements, Energy Transfer gathers natural gas from the producer, processes the natural gas and sells the resulting NGLs to third parties at market prices. Because the extraction of the NGLs from the natural gas during processing reduces the Btu content of the natural gas, Energy Transfer must either purchase natural gas at market prices for return to producers or make a cash payment to the producers equal to the value of this natural gas. Accordingly, under these arrangements, Energy Transfer's revenues and gross margins increase as the price of NGLs increases relative to the price of natural gas, and its revenues and gross margins decrease as the price of natural gas increases relative to the price of NGLs. In the latter case, Energy Transfer is generally able to reduce its commodity price exposure by bypassing its processing plants and not processing the natural gas, as described below.

In many cases, Energy Transfer provides services under contracts that contain a combination of more than one of the arrangements described above. The terms of its contracts vary based on gas quality conditions, the competitive environment at the time the contracts are signed and customer requirements. Its contract mix and, accordingly, its exposure to natural gas and NGL prices, may change as a result of changes in producer preferences, its expansion in regions where some types of contracts are more common and other market factors.

A significant benefit of Energy Transfer's ownership of the Oasis Pipeline is that Energy Transfer typically can elect not to process the natural gas at the La Grange processing plant when processing margins are unfavorable. Instead of processing the natural gas, Energy Transfer is able to bypass the La Grange processing plant and deliver natural gas meeting pipeline quality specifications by blending rich natural gas from the Southeast Texas System with lean natural gas transported on the Oasis pipeline.

Energy Transfer can also generally bypass the Elk City processing plant. The natural gas supplied to the Elk City System has a relatively low NGL content and does not require processing to meet pipeline quality specifications. During periods of unfavorable processing margins, Energy Transfer can bypass the Elk City processing plant and deliver the natural gas directly into connecting pipelines.

Both the Southeast Texas System and Elk City System are geographically located in natural gas producing areas that had large production volumes in the past several decades, and these systems were built to accommodate those larger volumes. Both of these producing areas have matured in recent years, and production has declined over time. As a result, utilization of these systems has also declined. At the time of Energy

**Table of Contents**

**Index to Financial Statements**

Transfer's acquisition of the Southeast Texas System and the Elk City System, both of these systems were not being fully utilized. By aggressively marketing directly to producers and consumers and adding connections to new customers, during 2003, Energy Transfer has increased the utilization of the Southeast Texas System and the Elk City System by approximately 30% and 50%, respectively. Energy Transfer believes that it has the opportunity to further leverage its existing asset base in order to more fully utilize the capacity of its systems and thereby increase throughput and cash flows. Generally, adding additional volumes to the Southeast Texas System's and the Elk City System's pipelines requires only minimal incremental capital expenditures. As a result, transporting additional volumes of natural gas through these pipelines generally provides incremental operating income without the need for additional capital.

Energy Transfer believes that it is more cost effective to install a pipeline with throughput capacity in excess of the natural gas production that is initially contracted for transportation on the pipeline. The capacity of a six-inch pipeline is more than double that of a four inch pipeline, yet the costs of construction are substantially less than double. In addition, the costs to operate and maintain the larger pipeline are generally no greater than the costs to operate and maintain the smaller pipeline.

However, Energy Transfer has a different approach to the construction and operation of processing and treating plants. Unutilized capacity in processing and treating facilities negatively impacts the per unit profitability of these facilities. Energy Transfer seeks to maximize throughput of its plants at both the time of installation and subsequently as production declines, by idling underutilized plants and aggregating its processing and treating operations at more efficient facilities to minimize the per unit cost of those plants. Idle or unused facilities can be relocated to other parts of Energy Transfer's systems if necessary or sold to third parties. Because aggregation can result in higher capital costs, the decision by Energy Transfer to idle a plant and aggregate processing and treating operations at a more efficient facility is made only when management believes that the per unit cost reduction justifies the capital expenditure. For the eleven months ended August 31, 2003, Energy Transfer's utilization of capacity at its Southeast Texas System processing and treating facilities were 40% and 32% respectively. For the reasons discussed above, this excess capacity negatively affected Energy Transfer's profitability that was reflected in its historical numbers. A portion of the excess capacity at the Southeast Texas System processing facility was directly attributable to its election to not process or treat natural gas and deliver the natural gas directly into the Oasis Pipeline in order to take advantage of high natural gas prices relative to NGL prices. Additionally, in September 2003, Energy Transfer enhanced its utilization by moving an idle 145 MMcf/d treating facility from the Southeast Texas System to the Elk City System to take advantage of additional natural gas volumes.

Energy Transfer conducts its marketing operations through its producer services business, in which Energy Transfer markets the natural gas that flows through its assets, which Energy Transfer refers to as on-system gas, and attracts other customers by marketing volumes of natural gas that do not move through its assets, which Energy Transfer refers to as off-system gas. For both on-system and off-system gas, Energy Transfer purchases natural gas from natural gas producers and other supply points and sells that natural gas to utilities, industrial consumers, other marketers and pipeline companies, thereby generating gross margins based upon the difference between the purchase and resale prices.

Most of Energy Transfer's marketing activities involve the marketing of its on-system gas. For the 11 months ended August 31, 2003, Energy Transfer marketed approximately 524 MMcf/d of natural gas, 86% of which was on-system gas. Substantially all of its on-system marketing efforts involve natural gas that flows

## Table of Contents

### Index to Financial Statements

through either the Southeast Texas System or the Oasis Pipeline. Energy Transfer markets only a small amount of natural gas that flows through the Elk City System.

For its off-system gas, Energy Transfer purchases gas or acts as an agent for small independent producers that do not have marketing operations. Energy Transfer develops relationships with natural gas producers which facilitates its purchase of their production on a long-term basis. Energy Transfer believes that this business provides it with strategic insights and valuable market intelligence which may impact its expansion and acquisition strategy.

#### *The Transportation Segment*

Results from Energy Transfer's Transportation segment are determined primarily by the amount of capacity Energy Transfer's customers reserve as well as the actual volume of natural gas that flows through the Oasis Pipeline. Under Oasis Pipeline customer contracts, Energy Transfer charges its customers a demand fee, a transportation fee, or a combination of both, generally payable monthly.

*Demand Fee.* The demand fee is a fixed fee for the reservation of an agreed amount of capacity on the Oasis Pipeline for a specified period of time. The customer is obligated to pay Energy Transfer the demand fee even if the customer does not transport natural gas on the Oasis Pipeline.

*Transportation Fee.* The transportation fee is based on the actual throughput of natural gas by the customer on the Oasis Pipeline.

For the 11 months ended August 31, 2003, Energy Transfer transported approximately 30% of its natural gas volumes on the Oasis Pipeline pursuant to long-term contracts. Its long-term contracts have a term of one year or more. Energy Transfer also enters into short-term contracts with terms of less than one year in order to utilize the capacity that is available on the Oasis Pipeline after taking into account the capacity reserved under Energy Transfer's long-term contracts. For the 11 months ended August 31, 2003, the Oasis Pipeline accounted for approximately 57% of Energy Transfer's fee-based gross margin.

#### *Operating Expenses and Administrative Costs*

Energy Transfer realizes significant economies of scale related to the Midstream segment as well as the Transportation segment. As additional volumes of natural gas move through Energy Transfer's systems, its incremental operating and administrative costs do not increase materially. Operating expenses are costs directly associated with the operations of a particular asset and include direct labor and supervision, property insurance, ad valorem taxes, repair and maintenance expenses, measurement and utilities. These costs are generally fixed across broad volume ranges. Energy Transfer's fuel expense to operate its pipelines and plants is more variable in nature and is sensitive to changes in volume and commodity prices.

#### *Effects of Changes in Commodity Price*



Energy Transfer's profitability is affected by volatility in prevailing NGL and natural gas prices. Historically, changes in the prices of most NGL products have generally correlated with changes in the price of crude oil. NGL and natural gas prices have been subject to significant volatility in recent years in response to changes in the supply and demand for NGL products and natural gas market uncertainty. For a discussion of the

**Table of Contents**

**Index to Financial Statements**

volatility of natural gas and NGL prices, please read Risk Factors Energy Transfer's profitability is dependent upon prices and market demand for natural gas and NGLs, which are beyond its control and have been volatile. The current mix of Energy Transfer's contractual arrangements described above together with its ability to bypass the processing plants significantly mitigates its exposure to the volatility of natural gas and NGL prices. Gas prices can also affect Energy Transfer's profitability indirectly by influencing drilling activity and related opportunities for natural gas gathering, compression, treating, processing, transportation and marketing.

## **Table of Contents**

### **Index to Financial Statements**

#### *Significant Acquisitions*

Energy Transfer acquired most of its assets in two strategic acquisitions. In October 2002, Energy Transfer acquired the Southeast Texas System, the Elk City System and a 50% equity interest in the Oasis Pipeline from Aquila Gas Pipeline, an affiliate of Aquila, Inc., for \$264 million in cash. In December 2002, Energy Transfer acquired the remaining 50% equity interest in the Oasis Pipeline from an affiliate of The Dow Chemical Company for \$87 million in cash.

Energy Transfer operates its assets differently than did Aquila Gas Pipeline. The differences in operations are as follows:

Aquila Gas Pipeline owned only a 50% equity interest in the Oasis Pipeline. As a result of Energy Transfer's 100% ownership of the Oasis Pipeline, it is able to achieve operating efficiencies that previously could not be achieved. These operating efficiencies include:

*bypassing the La Grange processing plant when processing margins are unfavorable;*

*blending natural gas into the Oasis Pipeline instead of treating this natural gas; and*

*reducing general and administrative costs.*

Aquila Gas Pipeline had more extensive marketing and trading operations than Energy Transfer does primarily as a result of the marketing and trading of substantial amounts of off-system gas which utilized storage facilities owned by its affiliates. Unlike Aquila Gas Pipeline, Energy Transfer does not own storage facilities, and Energy Transfer focuses its marketing activities on its on-system gas. As a result of Energy Transfer's focus on marketing its on-system gas, its ability to bypass the La Grange processing plant and its efforts to manage commodity price risk by balancing its purchases of natural gas with physical forward contracts and certain financial derivatives, we believe that Energy Transfer's revenues, earnings and gross margins will be substantially less volatile than Aquila Gas Pipeline's historical results.

In addition to the midstream business, Aquila, Inc. also participates in other areas of the energy industry including the regulated distribution of natural gas and electricity and non-regulated electric power generation. We believe that Energy Transfer's focus on midstream activities, as opposed to the diversified operations of Aquila Gas Pipeline's parent, will enable Energy Transfer to achieve additional operational efficiencies.

## **Results of Operations**

### ***Heritage Propane Partners***

Amounts discussed below reflect 100% of the results of M-P Energy Partnership. M-P Energy Partnership is a general partnership in which we own a 60% interest. Because M-P Energy Partnership is primarily engaged in lower-margin wholesale distribution, its contribution to our net

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income is not significant and the minority interest of this partnership is excluded from the EBITDA, as adjusted, calculation. All other financial

- 53 -

**Table of Contents**

**Index to Financial Statements**

information and operating data included in management's discussion and analysis of financial condition and results of operations includes references to the foreign wholesale results of M-P Energy Partnership.

*Fiscal Year Ended August 31, 2003 Compared to the Fiscal Year Ended August 31, 2002*

*Volume.* Total retail gallons sold in fiscal year 2003 were 375.9 million, an increase of 46.3 million from the 329.6 million gallons sold in fiscal year 2002. Of the increase in volume, approximately 6.0 million gallons was attributable to the volume added through acquisitions and approximately 40.3 million gallons was attributable to more favorable weather conditions in 2003 in some of our areas of operations, offset by warmer than normal weather conditions in other areas of operations.

We sold approximately 74.3 million wholesale gallons during fiscal year 2003 of which 15.3 million were domestic wholesale and 59.0 million were foreign wholesale. In fiscal year 2002, we sold 16.8 million domestic wholesale gallons and 65.3 million foreign wholesale gallons. The 6.3 million gallon decrease in foreign wholesale volumes of M-P Energy Partnership was primarily due to an exchange contract that was in effect during fiscal year 2002, which was not economical to renew during fiscal year 2003.

*Revenues.* Total revenues for fiscal year 2003 were \$571.4 million, an increase of \$109.1 million, as compared to \$462.3 million in fiscal year 2002. Retail revenues for fiscal year 2003 were \$463.4 million as compared to \$365.3 million for fiscal year 2002, an increase of \$98.1 million, of which \$40.9 million was primarily due to higher selling prices, and \$49.8 million was primarily due to the increase in gallons sold as a result of colder weather conditions, and \$7.4 million was due to the increase in gallons sold by customer service locations added through acquisitions. Selling prices in all the reportable segments increased from last year in response to higher supply costs. Domestic wholesale revenues increased \$0.7 million to \$10.7 million, due to an increase of approximately \$1.7 million related to higher selling prices, offset by a decrease of approximately \$1.0 million related to a decrease in gallons sold. Foreign wholesale revenues were \$36.6 million for fiscal year 2003 as compared to \$31.2 million for fiscal year 2002, an increase of \$5.4 million primarily due to an approximate \$9.3 million increase related to higher selling prices offset by an approximate \$3.9 million related to decreased volumes as described above. Net liquids marketing revenues increased to \$1.3 million in fiscal year 2003 from \$0.5 million in fiscal year 2002, primarily due to more favorable movement in product prices in the current fiscal year. Other domestic revenues increased by \$4.1 million to \$59.4 million for fiscal year 2003, compared to \$55.3 million for fiscal year ended 2002 primarily as a result of acquisitions.

*Cost of Products Sold.* Total cost of sales increased \$58.9 million to \$297.1 million as compared to \$238.2 million for fiscal year 2002. Retail fuel cost of sales increased \$51.7 million to \$236.3 million for fiscal year 2003, of which approximately \$29.1 million was due to increased volumes, and approximately \$22.6 million was due to higher supply costs. U.S. wholesale cost of sales decreased \$0.1 million to \$9.6 million. Foreign wholesale cost of sales increased \$4.7 million to \$34.0 million, of which approximately \$8.4 million was due to increased product costs this fiscal year, offset by an approximate decrease of \$3.7 million attributable to the decreased volumes described above. Other cost of sales increased \$2.6 million to \$17.2 million for fiscal year 2003 primarily due to acquisitions.

*Gross Profit.* Total gross profit increased to \$274.3 million in fiscal year 2003 as compared to \$224.1 million in fiscal year 2002, due to the aforementioned increases in volumes and revenues described above, and the results of acquisitions, offset in part by the increases in product costs. For fiscal year 2003, retail fuel gross profit was \$227.1 million, domestic wholesale fuel gross profit was \$1.1 million, liquids marketing gross profit



**Table of Contents**

**Index to Financial Statements**

was \$1.3 million, other gross profit was \$42.2 million, and foreign wholesale gross profit was \$2.6 million. As a comparison, for fiscal year 2002, we recorded retail fuel gross profit of \$180.7 million, domestic wholesale fuel gross profit of \$0.3 million, liquids marketing gross profit of \$0.5 million, other gross profit of \$40.6 million and foreign wholesale gross profit of \$2.0 million.

*Operating Expenses.* Operating expenses were \$152.1 million for fiscal year 2003 as compared to \$133.2 million for fiscal year 2002. The increase of \$18.9 million is primarily the result of \$6.8 million of additional operating expenses incurred for employee wages and benefits related to the growth of us from acquisitions made during fiscal year 2002, an increase of \$5.5 million in the performance-based compensation plan expense due to higher operating performance, an increase of approximately \$5.5 million in operating expenses in certain areas of our operations due to acquisitions and to accommodate increased winter demand and industry-wide increases in business insurance costs of \$1.1 million.

*Selling, General and Administrative.* Selling, general and administrative expenses were \$14.0 million for fiscal year 2003 as compared to \$13.0 million for fiscal year 2002. This increase is primarily related to the performance-based compensation plan expense in 2003 that was not incurred in 2002, offset by a \$0.7 million decrease in deferred compensation expense related to the adoption of FASB Statement No. 123 *Accounting for Stock-Based Compensation* (SFAS 123).

*Depreciation and Amortization.* Depreciation and amortization for fiscal year 2003 was \$37.9 million, an increase of \$0.9 million as compared to \$37.0 million in fiscal year 2002. The increase is attributable to current year acquisitions.

*Operating Income.* We reported operating income of \$70.2 million in fiscal year 2003 as compared to the operating income of \$41.0 million for fiscal year 2002. This increase is a combination of increased gross profit and a \$0.7 million increase due to the adoption of SFAS 123, offset by increased operating expenses described above.

*Interest Expense.* Interest expense for fiscal year 2003 was \$35.7 million, a decrease of \$1.6 million as compared to \$37.3 million in fiscal year 2002. The decrease was primarily attributable to the retirement of a portion of outstanding debt during the year.

*Other Expense.* Other expense for fiscal year 2003 was \$3.2 million, an increase of \$2.9 million as compared to \$0.3 million in fiscal year 2002. The increase was primarily attributable to the reclassification into earnings of a \$2.8 million loss on marketable securities in fiscal year 2003 that was previously recorded as accumulated other comprehensive loss on the balance sheet.

*Taxes.* Taxes for the year ended August 31, 2003 were \$1.0 million due to the tax expense incurred by our corporate subsidiaries and other franchise taxes owed. Of the \$1.0 million increase, \$0.3 million was incurred in connection with the liquidation of Guilford Gas Service, Inc. during the fiscal year ended August 31, 2003. There was no tax expense for these subsidiaries for the year ended August 31, 2002.

*Net Income.* We reported net income of \$31.1 million, or \$1.79 per limited partner unit, for fiscal year 2003, an increase of \$26.2 million from net income of \$4.9 million for fiscal year 2002. The increase is primarily the result of the increase in operating income, which includes a \$0.7 million decrease in expenses due to the adoption of SFAS 123, partially offset by the increase in other expenses and taxes described above.





**Table of Contents**

**Index to Financial Statements**

EBITDA, *as adjusted*. EBITDA, as adjusted, increased \$29.5 million to \$111.0 million for fiscal year 2003, as compared to EBITDA, as adjusted, of \$81.5 million for fiscal year 2002. This increase is due to the operating conditions described above and is a record level of EBITDA, as adjusted, for our fiscal year results. Please read footnote (c) under Heritage Propane Partners Selected Historical Financial and Operating Data .

***Energy Transfer***

Energy Transfer commenced operations on October 1, 2002 with the acquisition of the Southeast Texas System, the Elk City System and a 50% equity interest in Oasis Pipe Line Company from Aquila Gas Pipeline. On December 27, 2002, Energy Transfer acquired the remaining interest in Oasis Pipe Line. As a result, Energy Transfer's historical financial information for the period from October 1, 2002 to August 31, 2003, which is Energy Transfer's fiscal year end, has been derived from the historical financial statements of Energy Transfer.

Energy Transfer's historical financial information for periods prior to October 1, 2002 has been derived from the historical financial statements of Aquila Gas Pipeline. Prior to October 1, 2002, Aquila Gas Pipeline owned the Southeast Texas System, the Elk City System and a 50% equity interest in Oasis Pipe Line.

Therefore, we are comparing the results of operations of Energy Transfer for the 11 months ended August 31, 2003 to the results of operations of Aquila Gas Pipeline for the 9 months ended September 30, 2002.

***Historical 11 Months Ended August 31, 2003 Compared to Historical 9 Months Ended September 30, 2002***

***Revenues.*** Total revenues were \$1,008.7 million for the 11 months ended August 31, 2003 compared to \$933.1 million for the 9 months ended September 30, 2002, an increase of \$75.6 million or 8.1%. On an annualized basis this represents an 11.6% decrease.

Midstream revenues were \$978.1 million for the 11 months ended August 31, 2003 compared to \$933.1 million for the 9 months ended September 30, 2002, an increase of \$45.0 million or 4.8%. However, on an annualized basis this represents a 14.2% decrease. This annualized decrease was directly attributable to a reduction in natural gas and NGL daily sales volumes partially offset by higher natural gas and NGL sales prices.

Natural gas sales volumes were 524,000 MMBtu/d for the 11 months ended August 31, 2003 compared to 1,147,000 MMBtu/d for the 9 months ended September 30, 2002, a decrease of 623,000 MMBtu/d or 54.3%. NGL sales volumes were 12,857 Bbls/d for the 11 months ended August 31, 2003 compared to 18,881 Bbls/d for the 9 months ended September 30, 2002, a decrease of 6,024 Bbls/d or 31.9%. Natural gas sales volumes decreased significantly as a result of the smaller scope of Energy Transfer's marketing activities as compared to Aquila Gas Pipeline's extensive marketing and trading activities. NGL sales volumes decreased due to Energy Transfer's frequent election to bypass its La Grange processing plant and deliver unprocessed natural gas from its Southeast Texas System directly into the Oasis Pipeline during the portion of the 11 month period ended August 31, 2003 that it owned 100% of Oasis. Energy Transfer elected to bypass the La Grange processing plant to avoid unfavorable processing margins.

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Average realized natural gas sales prices were \$5.03 per MMBtu for the 11 months ended August 31, 2003 compared to \$2.72 per MMBtu for the 9 months ended September 30, 2002, an increase of \$2.31 per MMBtu or

- 56 -

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**Table of Contents**

**Index to Financial Statements**

85.0%. In addition, average realized NGL sales prices were \$0.41 per gallon for the 11 months ended August 31, 2003 compared to \$0.32 per gallon for the 9 months ended September 30, 2002, an increase of \$0.09 per gallon or 26.8%.

Transportation revenues were \$30.6 million for the 11 months ended August 31, 2003. Energy Transfer's results for the 9 month period ended September 30, 2002 and for the 3 month period ended December 27, 2002 exclude revenues of Oasis Pipe Line because Energy Transfer's investment in Oasis Pipe Line was treated as an equity method investment prior to December 27, 2002. Had Oasis Pipe Line been consolidated in both periods, Transportation revenues would have been \$38.6 million for the 11 months ended August 31, 2003 and \$24.7 million for the 9 months ended September 30, 2002, an increase of \$13.9 million or 56.3%. On an annualized basis this represents a 28.0% increase. This increase was due to an increase in volumes transported on the Oasis Pipeline from 912,584 MMBtu/d for the 9 months ended September 30, 2002 to 921,316 MMBtu/d for the 11 months ended August 31, 2003 and to an increase in the transportation rate on the Oasis Pipeline from \$0.09 per MMBtu for the 9 months ended September 30, 2002 to \$0.12 per MMBtu for the 11 months ended August 31, 2003. The increase in Energy Transfer's average transportation rate was achieved, in part, due to a widening of the difference, also known as the basis differential, between the average price for natural gas at the Katy Hub near Houston, Texas and the average price for natural gas at the Waha Hub in West Texas. The widening of the basis differential allows Energy Transfer to increase the transportation rates it charges between these points. The average basis differential for the 11 months ended August 31, 2003 was approximately \$0.28 per MMBtu as compared to \$0.11 per MMBtu for the 9 months ended September 30, 2002.

*Cost of Sales.* Total cost of sales was \$899.5 million for the 11 months ended August 31, 2003 compared to \$880.1 million for the 9 months ended September 30, 2002, an increase of \$19.4 million or 2.2%. On an annualized basis this represents a 16.4% decrease.

Midstream cost of sales was \$899.4 million for the 11 months ended August 31, 2003 compared to \$880.1 million for the 9 months ended September 30, 2002, an increase of \$19.3 million or 2.2%. However, on an annualized basis this represents a 16.4% decrease. This annualized decrease was primarily attributable to a reduction in volumes of natural gas and NGLs, partially offset by the increase in natural gas prices. The Transportation segment sold excess inventory during the 11 months ended August 31, 2003 resulting in a cost of sales of \$0.1 million. The Transportation segment only periodically engages in activities that generate cost of sales.

*Operating Expenses.* Operating expenses were \$19.1 million for the 11 months ended August 31, 2003 compared to \$12.7 million for the 9 months ended September 30, 2002, an increase of \$6.4 million or 50.0%. On an annualized basis this represents a 22.8% increase. This increase was due to the inclusion of approximately \$4.9 million of operating expenses associated with Oasis Pipe Line subsequent to December 27, 2002. Oasis Pipe Line's operating expenses were not included in Aquila Gas Pipeline's results for the 9 month period ended September 30, 2002, because Aquila Gas Pipeline accounted for its investment in Oasis Pipe Line under the equity method. Oasis Pipe Line's operating expenses on a standalone basis were \$4.7 million for the 9 months ended September 30, 2002 and \$6.6 million for the 11 months ended August 31, 2003.

*General and Administrative Expenses.* General and administrative expenses were \$16.0 million for the 11 months ended August 31, 2003 compared to \$9.6 million for the 9 months ended September 30, 2002, an increase of \$6.4 million or 66.7%. On an annualized basis this represents a 36.4% increase. This annualized

**Table of Contents**

**Index to Financial Statements**

increase resulted primarily from higher employee bonuses and increased travel and insurance costs as well as the inclusion of general and administrative expense of Oasis Pipe Line subsequent to December 27, 2002.

*Depreciation and Amortization.* Depreciation and amortization expense was \$13.4 million for the 11 months ended August 31, 2003 compared to \$22.9 million for the 9 months ended September 30, 2002, a decrease of \$9.5 million or 41.3%. On an annualized basis this represents a 51.9% decrease. Depreciation and amortization expense decreased for the 11 months ended August 31, 2003 primarily due to the acquisition of midstream assets from Aquila Gas Pipeline, which resulted in a reduction in the depreciable basis on which these assets are depreciated. Aquila Gas Pipeline's book value of the acquired assets significantly exceeded Energy Transfer's book value in them. In addition, Aquila Gas Pipeline amortized \$2.4 million during the 9 months ended September 30, 2002 related to a transportation rights contract that has expired. This decrease was partially offset by the inclusion of \$2.8 million of depreciation and amortization expense of Oasis Pipe Line subsequent to December 27, 2002.

*Unrealized Loss (Gain) on Derivatives.* The unrealized gain on derivatives was \$0.9 million for the 11 months ended August 31, 2003 compared to an unrealized loss of \$5.0 million for the 9 months ended September 30, 2002. Derivative price changes worked to the detriment of Aquila Gas Pipeline during the 9 months ended September 30, 2002.

*Equity in Net Income (Loss) of Affiliates.* Equity in net income of affiliates was \$1.4 million for the 11 months ended August 31, 2003 compared to \$5.4 million for the 9 months ended September 30, 2002, a decrease of \$4.0 million or 73.8%. This decrease resulted from equity in net income (loss) of affiliates for the 11 months ended August 31, 2003 not reflecting any equity earnings associated with Oasis Pipe Line subsequent to December 27, 2002 while Oasis Pipe Line's earnings were recognized under the equity method of accounting for the 3 months ended December 27, 2002 and the 9 months ended September 30, 2002. Equity earnings from Oasis Pipe Line included in total equity in net income (loss) of affiliates was \$1.6 million and \$5.4 million for the 3 months ended December 27, 2002 and 9 months ended September 30, 2002, respectively.

*Interest Expense.* Interest expense was \$12.1 million for the 11 months ended August 31, 2003 compared to \$3.9 million for the 9 months ended September 30, 2002, an increase of \$8.2 million or 210.3%. The increase was primarily due to the increased borrowings used to finance the purchase of midstream assets from Aquila Gas Pipeline and Dow Hydrocarbons Resources, Inc.

*Income Tax Expense.* Income tax expense was \$4.4 million for the 11 months ended August 31, 2003 compared to a benefit of \$0.5 million for the 9 months ended September 30, 2002. As a partnership, Energy Transfer is not subject to income taxes. However, Energy Transfer's subsidiary, Oasis Pipe Line, is a corporation that is subject to income taxes at an effective rate of 35%. The benefit for the 9 months ended September 30, 2002 was related to the operating results of Aquila Gas Pipeline, which is a corporation subject to income taxes.

*Net Income.* Energy Transfer's net income for the 11 months ended August 31, 2003 was \$46.6 million compared to \$4.7 million for the 9 months ended September 30, 2002, an increase of \$41.9 million. The increase in net income was due to the reasons described above.

**Table of Contents**

**Index to Financial Statements**

**Liquidity and Capital Resources**

Our ability to satisfy our obligations will depend on our future performance, which will be subject to prevailing economic, financial, business and weather conditions, and other factors, many of which are beyond our control.

***Heritage Propane Partners Future Capital Requirements***

Our future capital requirements for our retail propane operations will generally consist of:

maintenance capital expenditures;

growth capital expenditures, mainly for customer tanks; and

acquisition capital expenditures.

We believe that cash generated from the operations of our propane business will be sufficient to meet anticipated propane maintenance capital expenditures, which we anticipate will be approximately \$15.5 million during fiscal 2004. We will initially finance all our propane capital requirements by cash flows from propane operating activities. To the extent our future propane capital requirements exceed cash flows from propane operating activities:

propane maintenance capital expenditures will be financed by the proceeds of borrowings under the working capital facility of our operating partnership, Heritage Operating, L.P. described below, which will be repaid by subsequent seasonal reductions in inventory and accounts receivable;

propane growth capital expenditures will be financed by the proceeds of borrowings under the acquisition facility of Heritage Operating; and

propane acquisition capital expenditures will be financed by the proceeds of borrowings under the acquisition facility of Heritage Operating, other lines of credit, long-term debt, the issuance of additional common units or a combination thereof.

The assets utilized in the propane business do not typically require lengthy manufacturing process time or complicated, high technology components. Accordingly, we do not have any significant financial commitments for maintenance capital expenditures in our propane business. In addition, we have not experienced any significant increases attributable to inflation in the cost of these assets or in our propane operations.

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Acquisition capital expenditures, which include expenditures related to the acquisition of retail propane operations and intangibles associated with such acquired businesses, were \$24.9 million for the fiscal year ended August 31, 2003 as compared to \$19.7 million for fiscal year 2002. In addition to the \$24.9 million of cash expended for acquisitions of retail propane operations during fiscal year 2003, \$15.0 million of common units and \$0.9 million for notes payable on non-compete agreements were issued and \$1.0 million in liabilities were assumed in connection with certain acquisitions. In comparison, in addition to the \$19.7 million of cash expended for acquisitions of retail propane operations during the fiscal year ended August 31, 2002, \$2.7 million for notes payable on non-compete agreements were issued in connection with such acquisitions.

- 59 -

**Table of Contents**

**Index to Financial Statements**

***Energy Transfer Future Capital Requirements***

We anticipate that our future capital requirements for the Energy Transfer business will consist of:

maintenance capital expenditures, which include capital expenditures made to connect additional wells to Energy Transfer's systems in order to maintain or increase throughput on existing assets;

growth capital expenditures, mainly to expand and upgrade gathering systems, transportation capacity, processing plants or treating plants; and

acquisition capital expenditures, including to construct new pipelines, processing plants and treating plants.

We believe that cash generated from the operations of the Energy Transfer business will be sufficient to meet its anticipated maintenance capital expenditures, which we anticipate will be approximately \$6 million during fiscal 2004. We will initially finance all of Energy Transfer's capital requirements by cash flow from the Energy Transfer business. To the extent Energy Transfer's future capital requirements exceed cash flows from the Energy Transfer business:

Energy Transfer's maintenance capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility which will be repaid from subsequent cash flows generated from the Energy Transfer business;

Energy Transfer's growth capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility; and

Energy Transfer's acquisition capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility, other lines of credit, long-term debt, the issuance of additional common units or a combination thereof.

The assets utilized in the Energy Transfer businesses, including pipelines, gathering systems and related facilities, are generally long-lived assets and do not require significant maintenance capital expenditures.

We anticipate that we will continue to invest significant amounts of capital to construct and acquire midstream assets. For example, Energy Transfer has announced that it intends to construct the Bossier Pipeline connecting its Katy Pipeline in Grimes County to natural gas supplies in east Texas. We anticipate that the Bossier Pipeline will require capital expenditures of approximately \$75 million to complete, and we expect to complete the Bossier Pipeline by mid-2004.

***Heritage Propane Partners Cash Flows***

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*Operating Activities.* Cash provided by operating activities for fiscal year 2003 was \$95.2 million as compared to cash provided by operating activities of \$65.4 million for fiscal year 2002. The net cash provided from operations of \$95.2 million for fiscal year 2003 consisted of net income of \$31.1 million and non-cash

- 60 -



**Table of Contents**

**Index to Financial Statements**

charges of \$43.2 million, primarily depreciation and amortization, and a decrease in working capital items of \$20.9 million.

*Investing Activities.* We completed six acquisitions during fiscal year 2003 investing \$24.9 million, net of cash received. This capital expenditure amount is reflected in the cash used in investing activities of \$48.4 million along with \$15.1 million invested for maintenance needed to sustain operations at current levels and \$12.2 million for customer tanks and other expenditures to support growth of operations. Investing activities also includes proceeds from the sale of property of \$3.8 million.

*Financing Activities.* Cash used in financing activities of \$44.3 million during fiscal year 2003 was primarily comprised of a net decrease in short-term debt of \$3.5 million, a net decrease in long-term debt of \$41.1 million and \$43.4 million of cash distributions paid to unitholders and our general partner, offset by \$44.5 million of net proceeds from the issuance of common units and \$0.2 million contributed by our general partner to maintain its general partner interest in us.

***Energy Transfer Company Cash Flows***

*Operating Activities.* Energy Transfer Company's net cash provided by operating activities was \$70.9 million for the 11 months ended August 31, 2003. The net cash provided from operations consisted of net income of \$46.6 million and non-cash charges of \$15.8 million, primarily depreciation and amortization, and a decrease in working capital and certain long-term liabilities of \$8.9 million. Additionally, Energy Transfer Company's operating cash flow was negatively impacted by the difference between equity earnings and dividends from equity investments of \$0.4 million.

*Investing Activities.* Energy Transfer Company's net cash used in investing activities was \$341.2 million for the 11 months ended August 31, 2003. Approximately \$337.1 million (net of acquired cash through acquisitions) was invested by Energy Transfer Company for the acquisition of the midstream assets and the 50% interest in Oasis Pipe Line previously owned by Aquila Gas Pipeline and the purchase of the remaining 50% interest in Oasis Pipe Line previously owned by Dow Hydrocarbons Resources, Inc. During this period, Energy Transfer Company sold its 20% interest in the Nustar Joint Venture, which Energy Transfer Company determined was not a strategic asset. No gain or loss was recognized as a result of the sale. Energy Transfer's net proceeds from the sale of its interest in Nustar was \$9.6 million. Capital expenditures were \$13.9 million during the 11 months ended August 31, 2003.

*Financing Activities.* Energy Transfer Company's net cash used in financing activities was \$323.4 million for the 11 months ended August 31, 2003. Energy Transfer Company borrowed \$239.5 million, net of financing fees, for the purpose of financing the acquisition activity discussed above. Energy Transfer Company retired \$20.0 million of this debt during this same period and made a \$4.8 million distribution to its partners in April 2003. The partners of Energy Transfer Company contributed \$108.7 million to initially capitalize Energy Transfer Company.

***Financing and Sources of Liquidity***

Following the consummation of the Energy Transfer Transaction, we have maintained separate credit facilities for each of Heritage Operating and Energy Transfer Company. Each credit facility is secured only by



**Table of Contents**

**Index to Financial Statements**

the assets of the operating partnership that it finances, and neither operating partnerships nor its subsidiaries guarantees the debt of the other operating partnership.

*Heritage Propane Partners Facilities.* We have a bank credit facility with various financial institutions that is for the exclusive use of Heritage Operating, which includes a working capital facility, providing for up to \$65.0 million of borrowings to be used for working capital and other general partnership purposes, and an acquisition facility, providing for up to \$50.0 million of borrowings to be used for retail propane acquisitions and improvements. The bank credit facility is secured by all receivables, contracts, equipment, inventory and general intangibles of Heritage Operating. Under the terms of the bank credit facility agreement, the working capital facility is set to expire June 30, 2004 and the acquisition facility was set to expire December 31, 2003, at which time the outstanding balance on the acquisition facility was to convert to a term loan payable in quarterly installments with a final maturity of June 30, 2006. We are currently negotiating and expect to enter into an amendment to the bank credit facility to increase the amount available to be borrowed under each of the working capital facility and the acquisition facility to up to \$75 million and to extend the maturity of each facility to December 31, 2006. The weighted average interest rate was 2.49% for the amounts outstanding at August 31, 2003 on both the working capital facility and the acquisition facility. At August 31, 2003, there was \$38.3 million available for borrowing under the working capital facility and \$25.3 million available under the acquisition facility.

*Energy Transfer Facilities.* In connection with the Energy Transfer Transaction, Energy Transfer Company entered into a new credit facility with its existing lenders providing for a four-year non-amortizing term loan of up to \$325 million and a \$125 million revolving credit facility. The term loan, which is in the amount of \$325 million, was used to fund a \$50.0 million payment related to the Energy Transfer Transaction, to retire Energy Transfer Company's existing credit facilities, satisfy Energy Transfer Company's accounts payable and other specified liabilities as they become due and fund certain other expenses in connection with the Energy Transfer Transaction. The interest rate will fluctuate based on a ratio of total funded debt to EBITDA. At Energy Transfer Company's option, interest shall be payable at the alternative base rate plus an applicable margin ranging from 0.75% to 1.75% or the Eurodollar rate plus an applicable margin ranging from 2.00% to 3.00%. The revolving credit facility provides for up to \$125 million in borrowings and may be utilized for general working capital needs, issuance of letters of credit, funding of the construction of the proposed Bossier Pipeline and financing of other capital expenditures for acquisitions and growth projects. The Energy Transfer Company credit facility will be fully secured by substantially all of Energy Transfer Company's assets. We may refinance the Energy Transfer Company credit facility at a later date with other bank debt, private placement debt with institutional investors, a public debt offering, a public equity offering, or a combination of one or more of the foregoing.

*Note Obligations.* In connection with our initial public offering, on June 25, 1996, Heritage Operating entered into a Note Purchase Agreement whereby Heritage Operating issued \$120 million principal amount of 8.55% Senior Secured Notes to institutional investors. Interest is payable semi-annually in arrears on each December 31 and June 30. These notes have a final maturity of June 30, 2011, with ten equal mandatory repayments of principal, which began on June 30, 2002. At August 31, 2003, \$96 million principal amount of the notes was outstanding.

On November 19, 1997, Heritage Operating entered into a Note Purchase Agreement that provided for the issuance of up to \$100 million of senior secured promissory notes if certain conditions were met, which we refer to as our medium term note program. An initial placement of \$32 million (Series A and B), at an average

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**Table of Contents****Index to Financial Statements**

interest rate of 7.23% with an average 10-year maturity, was completed at the closing of the medium term note program. Interest is payable semi-annually in arrears on each November 19 and May 19. An additional placement of \$15 million (Series C, D and E), at an average interest rate of 6.59% with an average 12-year maturity, was completed in March 1998. Interest is payable on Series C and D semi-annually in arrears on each September 13 and March 13. The proceeds of the placements were used to refinance amounts outstanding under the acquisition facility. No future placements are permitted under the unused portion of the medium term note program. During the fiscal year ended August 31, 2003, Heritage Operating used \$3.9 million and \$5.0 million of the proceeds from the issuance of 1,610,000 common units to retire the balance of the Series D and Series E senior secured notes. At August 31, 2003, \$34.1 million principal amount of medium term notes was outstanding.

On August 10, 2000, Heritage Operating entered into a Note Purchase Agreement that provided for the issuance of up to \$250 million of fixed rate senior secured promissory notes if certain conditions were met. An initial placement of \$180 million (Series A through F), at an average rate of 8.66% with an average 13-year maturity, was completed in conjunction with our merger with U.S. Propane. Interest is payable quarterly. The proceeds were used to finance the transaction with U.S. Propane and retire a portion of existing debt. On May 24, 2001, Heritage Operating issued an additional \$70 million (Series G through I) of the senior secured promissory notes to a group of institutional lenders with 7-, 12- and 15-year maturities and an average coupon rate of 7.66%. Heritage Operating used the net proceeds from the senior secured promissory notes to repay the balance outstanding under the acquisition facility and to reduce other debt. Interest is payable quarterly. During the fiscal year ended August 31, 2003, Heritage Operating used \$7.5 million and \$19.5 million of the proceeds from our issuance of 1,610,000 common units to retire a portion of the Series G and Series H senior secured promissory notes, respectively. At August 31, 2003, \$223 million principal amount of senior secured promissory notes was outstanding.

*Covenants.* The note agreements for each of the senior secured notes, medium term note program and senior secured promissory notes and the Heritage Operating bank credit facility contain customary restrictive covenants applicable to Heritage Operating, including limitations on the level of additional indebtedness, creation of liens and sale of assets. These covenants require Heritage Operating to maintain ratios of consolidated funded indebtedness to consolidated EBITDA (as these terms are similarly defined in the Heritage Operating bank credit facility and the note agreements) of not more than 5.00 to 1 for the Heritage Operating bank credit facility and not more than 5.25 to 1 for the note agreements and consolidated EBITDA to consolidated interest expense (as these terms are similarly defined in the Heritage Operating bank credit facility and the note agreements) of not less than 2.25 to 1. The consolidated EBITDA used to determine these ratios is calculated in accordance with these debt agreements. For purposes of calculating the ratios under the Heritage Operating bank credit facility and the note agreements, consolidated EBITDA is based upon its EBITDA, as adjusted, during the most recent four quarterly periods and modified to give pro forma effect for acquisitions and divestitures made during the test period and is compared to consolidated funded indebtedness as of the test date and the consolidated interest expense for the most recent twelve months. The debt agreements also provide that Heritage Operating may declare, make, or incur a liability to make a restricted payment during each fiscal quarter, if: (a) the amount of such restricted payment, together with all other restricted payments during such quarter, do not exceed available cash with respect to the immediately preceding quarter; and (b) no default or event of default exists before such restricted payment and after giving effect thereto. The debt agreements further provide that available cash is required to reflect a reserve equal to 50% of the interest to be paid on the notes. In addition, in the third, second and first quarters preceding a quarter in which a scheduled principal

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**Table of Contents**

**Index to Financial Statements**

payment is to be made on the notes, available cash is required to reflect a reserve equal to 25%, 50% and 75%, respectively, of the principal amount to be repaid on such payment dates.

The new Energy Transfer credit facility contains customary restrictive covenants applicable to Energy Transfer Company, including limitations on the level of additional indebtedness, creation of liens and sale of assets. These covenants also require Energy Transfer Company to maintain ratios of (1) consolidated funded indebtedness to consolidated EBITDA (as such terms are defined in the new Energy Transfer Company credit facility) of not more than 4.0 to 1, (2) adjusted consolidated funded indebtedness to adjusted consolidated EBITDA (as these terms are defined in the new Energy Transfer Company credit facility) of not more than (x) 5.25 to 1 from the closing date of the Energy Transfer Transaction to November 30, 2005 and (y) 5.0 to 1 on any applicable date of determination thereafter, and (3) consolidated EBITDA to consolidated interest expense (as these terms are defined in the new Energy Transfer Company credit facility) of not less than 2.75 to 1. The financial ratios described in clause (1) and (2) above are calculated quarterly, and the financial ratio described in clause (3) above is calculated with respect to a period of four consecutive quarters. Consolidated EBITDA is based upon the net income of Energy Transfer Company and its consolidated subsidiaries and is modified to give pro forma effect to the Bossier Pipeline for the ratios described in clauses (1) and (2) above and for acquisitions and divestitures made during any period of determination for purposes of all three ratios described above. The credit facility also provides that Energy Transfer Company may make distributions to us or make other specified payments (each referred to as a restricted payment ) during each fiscal quarter, if: (a) the amount of such restricted payment, together with all other restricted payments during such quarter, does not exceed available cash (defined in a manner similar to the definition of available cash in our partnership agreement) with respect to the immediately preceding quarter; and (b) no event of default exists before such restricted payment and after giving effect thereto.

Failure to comply with the various restrictive and affirmative covenants of the Heritage Operating bank credit facility and the note agreements could negatively impact our ability to incur additional debt and to pay distributions. We are required to measure these financial tests and covenants quarterly and were in compliance with all financial requirements, tests, limitations and covenants related to financial ratios under the senior secured notes, medium term note program, senior secured promissory notes and the Heritage Operating bank credit facility at August 31, 2003. Failure to comply with the various restrictive and affirmative covenants of the new Energy Transfer Company credit facility also could negatively impact our ability to incur additional debt and to pay distributions.

*Cash Distributions.* We use our cash provided by operating activities and borrowings under our working capital facilities to provide distributions to our unitholders. Under our partnership agreement, we will distribute to our general partner and our limited partners, 45 days after the end of each fiscal quarter, an amount equal to all of our available cash for such quarter. Available cash generally means, with respect to any quarter, all cash on hand at the end of such quarter less the amount of cash reserves established by our general partner in its reasonable discretion that are necessary or appropriate to provide for future cash requirements. Our commitment to our unitholders is to distribute increases in our cash flow while maintaining prudent reserves for our operations. The distribution was \$0.6375 per unit (\$2.55 annually) for each of the quarters ended February 28, 2002 through and including May 31, 2003. We raised the quarterly distribution \$0.0125 per unit for the quarter ended August 31, 2003, to \$0.65 per unit (\$2.60 annually). We have also declared a cash distribution of \$0.65 per common unit on our outstanding units for the first quarter of fiscal year 2004, which distribution was paid on January 14, 2004 to holders of record as of December 30, 2003. The current distribution level includes

**Table of Contents****Index to Financial Statements**

incentive distributions payable to our general partner to the extent the quarterly distribution exceeds \$0.55 per unit (\$2.20 annually).

**Heritage Operating Contractual Obligations**

The following table summarizes the long-term debt and other contractual obligations of Heritage Operating as of August 31, 2003:

|                             | Payments Due by Period |                  |                  |                  |                   |
|-----------------------------|------------------------|------------------|------------------|------------------|-------------------|
|                             | Total                  | Less Than        |                  |                  | More Than         |
|                             |                        | 1 Year           | 1-3 Years        | 3-5 Years        | 5 Years           |
|                             | (In thousands)         |                  |                  |                  |                   |
| Long-term debt              | \$ 399,071             | \$ 38,309        | \$ 88,762        | \$ 83,737        | \$ 188,263        |
| Operating lease obligations | 8,856                  | 2,916            | 3,231            | 1,863            | 846               |
| <b>Totals</b>               | <b>\$ 407,927</b>      | <b>\$ 41,225</b> | <b>\$ 91,993</b> | <b>\$ 85,600</b> | <b>\$ 189,109</b> |

See Note 4 Working Capital Facility and Long-Term Debt to the Consolidated Financial Statements beginning on Page F-1 of our Annual Report on Form 10-K for the fiscal year ended August 31, 2003 for further discussion of the long-term debt classifications and the maturity dates and interest rates related to long-term debt.

**Energy Transfer Company Contractual Obligations**

The following table summarizes Energy Transfer Company's long-term debt and other contractual obligations as of August 31, 2003:

|                             | Payments Due by Period |                  |                   |             |           |
|-----------------------------|------------------------|------------------|-------------------|-------------|-----------|
|                             | Total                  | Less Than        |                   |             | More Than |
|                             |                        | 1 Year           | 1-3 Years         | 3-5 Years   | 5 Years   |
|                             | (In thousands)         |                  |                   |             |           |
| Long term debt              | \$ 226,000             | \$ 30,000        | \$ 196,000        | \$          | \$        |
| Operating lease obligations | 2,244                  | 920              | 1,323             | 1           |           |
| <b>Total</b>                | <b>\$ 228,244</b>      | <b>\$ 30,920</b> | <b>\$ 197,323</b> | <b>\$ 1</b> | <b>\$</b> |

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The above table does not include any commodity physical contract commitments for natural gas or NGLs. Energy Transfer Company has forward commodity contracts, which will be settled by physical delivery. Short-term contracts, which expire in less than one year, require delivery of up to 54,000 MMBtu/d. Long-term contracts require delivery of up to 156,000 MMBtu/d. The long-term contracts run through July 2013.

A portion of the proceeds from the public offering of common units completed in January 2004 were used to retire all of the long term debt described above. In connection with the Energy Transfer Transaction, we obtained a new Energy Transfer Company credit facility described in Liquidity and Capital Resources Financing and Sources of Liquidity Energy Transfer Facilities.

### **New Accounting Standards**

In June 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. We adopted the provisions of SFAS 146 effective for exit or disposal activities that are initiated after December 31, 2002. The adoption did not have a material impact on our consolidated financial position or results of operations.

## **Table of Contents**

### **Index to Financial Statements**

In November 2002, the FASB issued Financial Interpretation No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). FIN 45 expands the existing disclosure requirements for guarantees and requires that companies recognize a liability for guarantees issued after December 31, 2002. The implementation of FIN 45 did not have a significant impact on our financial position or results of operations.

In January of 2003, the FASB issued Financial Interpretation No. 46 *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51* (FIN 46). FIN 46 clarifies Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. If certain conditions are met, this interpretation requires the primary beneficiary to consolidate certain variable interest entities in which equity investors lack the characteristics of a controlling interest or do not have sufficient equity investment at risk to permit the variable interest entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for variable interest entities created or obtained after January 31, 2003. For variable interest entities acquired before February 1, 2003, the interpretation is effective for the first fiscal year or interim period beginning after June 15, 2003. Management does not believe FIN 46 will have a significant impact on our financial position or results of operations.

In April 2003, the FASB issued Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (SFAS 149). SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS 133. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. We adopted SFAS 149 as of July 1, 2003. The adoption of SFAS 149 did not have a material impact on our consolidated financial position or results of operations.

In May 2003, the FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within the scope of SFAS 150 as a liability (or an asset in some circumstances). This statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We adopted the provisions of SFAS 150 as of September 1, 2003. The adoption did not have a material impact on our consolidated financial position or results of operations.

### **Critical Accounting Policies and Estimates**

#### ***Heritage Propane Partners***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to establish accounting policies and make estimates and assumptions that affect reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We evaluate its policies and estimates on a regular basis. Actual results could differ from these estimates.



**Table of Contents**

**Index to Financial Statements**

Our significant accounting policies are discussed in Note 2 – Summary of Significant Accounting Policies and Balance Sheet Detail to the Consolidated Financial Statements beginning on page F-1 of our Annual Report on Form 10-K for the fiscal year ended August 31, 2003. We believe the following are critical accounting policies:

*Marketable Securities.* We have marketable securities that are classified as available-for-sale. Unrealized holding losses occur as a result of declines in the market value of our holdings. The fair market value of our holdings is determined based upon the market price of the securities, which are publicly traded securities. Based on the performance of the securities over the preceding nine-month period, we review the fair market value to determine if an other-than temporary impairment should be recorded.

*Long-Lived Assets.* We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. We perform this review by considering if the carrying values of the assets exceed the undiscounted cash flows expected to result from the use and eventual disposition of the assets. If such a review should indicate that the carrying amount of long-lived assets is not recoverable, we reduce the carrying amount of such assets to fair value. We have never recorded an impairment as a result of this review.

*Stock Based Compensation Plans.* We account for its stock compensation plans following the fair value recognition method. We adopted this accounting method on a prospective basis beginning on September 1, 2002 for all stock based compensation granted to date by us. This method was adopted as we believe it is the preferable method of accounting for stock based compensation. Please see the caption – Stock Based Compensation Plans in Note 2 – Summary of Significant Accounting Policies and Balance Sheet Detail to the Consolidated Financial Statements beginning on page F-1 of our Annual Report on Form 10-K for the fiscal year ended August 31, 2003 for additional information about this adoption and a comparison to amounts recorded in prior periods.

*Depreciation of Property, Plant, and Equipment.* We calculate depreciation using the straight-line method based on the estimated useful lives of the assets ranging from 5 to 30 years. Changes in the estimated useful lives of the assets could have a material effect on our results of operation. We do not anticipate future changes in the estimated useful live of its property, plant, and equipment.

*Amortization of Intangible Assets.* We calculate amortization using the straight-line method over periods ranging from 2 to 15 years. We use amortization methods and determines asset values based on management’s best estimate using reasonable and supportable assumptions and projections. Changes in the amortization methods or asset values could have a material effect on our results of operations. We do not anticipate future changes in the estimated useful lives of our intangible assets.

*Fair Value of Derivative Commodity Contracts.* We enter into commodity forward, swaps and options contracts involving propane and related products, which, in accordance with SFAS No. 133 – Accounting for Derivative Instruments and Hedging Activities, are not accounting hedges, but are used for risk management trading purposes. To the extent such contracts are entered into at fixed prices and thereby subject us to market risk, the contracts are accounted for using the fair value method. Under this valuation method, derivatives are carried in the consolidated balance sheets at fair value with changes in value recognized in earnings. We classify all gains and losses from these derivative contracts entered into for risk management purposes as liquids marketing revenue in the consolidated statement of operations. We utilize published settlement prices for

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**Table of Contents**

**Index to Financial Statements**

exchange-traded contracts, quotes provided by brokers and estimates of market prices based on daily contract activity to estimate the fair value of these contracts. Changes in the methods used to determine the fair value of these contracts could have a material effect on our results of operations. We do not anticipate future changes in the methods used to determine the fair value of these derivative contracts.

***Energy Transfer***

The following discussion summarizes Energy Transfer's critical accounting policies.

**Revenue Recognition.** Energy Transfer recognizes revenue for sales of natural gas and NGLs upon delivery. Service revenues, including transportation, compression, treating and gas processing, are recognized at the time service is performed. Transportation capacity payments are recognized when earned in the period the capacity was made available.

**Commodity Risk Management.** In 1999, Aquila Gas Pipeline transferred all of its trading operations to Aquila Energy Marketing, a wholly owned subsidiary of Aquila, Inc. Aquila Energy Marketing entered into forward physical contracts with third parties for the benefit of Aquila Gas Pipeline and where deemed necessary entered into intercompany financial derivative positions, such as swaps, futures and options, with Aquila Gas Pipeline and other affiliates to assist them in managing their exposures. As a result, Aquila Gas Pipeline had forward physical contracts with third parties and financial derivative positions with Aquila Energy Marketing and its affiliates. Aquila Gas Pipeline received the margins associated with these transactions, and Aquila Energy Marketing charged Aquila Gas Pipeline for its share of Aquila Energy Marketing's cost to manage Aquila Gas Pipeline's positions.

Aquila Gas Pipeline accounted for its derivative positions, both speculative forward positions and financial derivatives, under Emerging Issues Task Force Issue 98-10 *Accounting for Contracts Involved in Energy Trading and Risk Management Activities* ( EITF 98-10 ). Under EITF 98-10, Aquila Gas Pipeline valued the derivative positions at market value with all changes being recognized in earnings. Realized gains and losses were included in revenues, while unrealized gains and losses were classified as such in the consolidated statements of income. Aquila Gas Pipeline's derivative positions were classified on its balance sheet as current or long-term price risk management assets and liabilities based on their maturity. Although Energy Transfer is also involved in energy marketing activities and use derivatives to manage its exposures, Energy Transfer did not purchase the derivative positions of Aquila Gas Pipeline when it purchased the assets of Aquila Gas Pipeline.

Effective in the fourth quarter of 2002, the Emerging Issues Task Force issued Issue 02-03, which rescinded EITF 98-10. As a result all energy trading derivative transactions are now governed by Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS No. 133 ). SFAS No. 133 as amended by Statement of Financial Accounting Standards No. 138, *Accounting for Certain Derivative Activities and Certain Hedging Activities* ( SFAS 138 ), requires that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair market value. The statements require that changes in the derivative's fair value be recognized currently in earnings unless specific hedge criteria are met. Special accounting for qualifying hedges allows a derivative's gain and loss to offset related results on the hedged item in the income statement and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

**Table of Contents**

**Index to Financial Statements**

Energy Transfer utilizes various exchange-traded and over-the-counter commodity financial instrument contracts to limit its exposure to margin fluctuations in natural gas and NGL prices. These contracts consist primarily of futures and swaps. As its financial derivative positions are typically short-term positions, Energy Transfer has generally elected not to designate them as hedges under SFAS No. 133, although Energy Transfer believes some of them would qualify as hedges if they were designated as such. As a result, the net gain or loss arising from marking to market these positions is recognized currently in earnings.

In the course of normal operations, Energy Transfer also routinely enters into forward physical contracts for the purchase and sale of natural gas and NGLs along various points of its systems. These positions require physical delivery and are treated as normal purchases and sales contracts under SFAS No. 133. Accordingly, unlike Aquila Gas Pipeline under EITF 98-10, under EITF 02-03 and SFAS No. 133, Energy Transfer does not mark these contracts to market on its financial statements. They are accounted for at the time of delivery.

The market prices used to value forward physical contracts and financial derivatives at Aquila Gas Pipeline and financial derivatives at Energy Transfer reflect management's estimates considering various factors, including closing exchange and over-the-counter quotations and the time value of the underlying commitments. The values have been adjusted to reflect the potential impact of liquidating a position in an orderly manner over a reasonable period of time under existing market conditions.

*Property, Plant and Equipment.* Pipeline, property, plant, and equipment are stated at cost. Maintenance capital expenditures are capital expenditures made to replace partially or fully depreciated assets in order to maintain the existing operating capacity of Energy Transfer's assets and to extend their useful lives. Maintenance capital expenditures also include capital expenditures made to connect additional wells to Energy Transfer's systems in order to maintain or increase throughput on its existing assets. Expansion capital expenditures are capital expenditures made to expand the existing operating capacity of its assets, whether through construction or acquisition. Energy Transfer treats repair and maintenance expenditures that do not extend the useful life of existing assets as operating expenses as Energy Transfer incurs them. Upon disposition or retirement of pipeline components or gas plant components, any gain or loss is recorded to accumulated depreciation. When entire pipeline systems, gas plants or other property and equipment are retired or sold, any gain or loss is included in operations.

Depreciation of the pipeline systems, gas plants and processing equipment is provided using the straight-line method based on an estimated useful life of primarily twenty years. The Oasis Pipeline is depreciated based on an estimated useful life of sixty-five years.

Energy Transfer reviews its assets for impairment whenever facts and circumstances indicate impairment may be present. When impairment indicators are present, Energy Transfer evaluates whether the assets in question are able to generate sufficient cash flows to recover their carrying value on an undiscounted basis. If not, Energy Transfer impairs the assets to the fair value, which may be determined based on discounted cash flows.

**Table of Contents**

**Index to Financial Statements**

**Quantitative and Qualitative Disclosures About Market Risk**

***Heritage Propane Partners***

*Interest Rate Exposure.* We have little cash flow exposure due to interest rate changes for long-term debt obligations. We had \$51.4 million of variable rate debt outstanding as of August 31, 2003. The variable rate debt consists of the bank credit facility described elsewhere in this report. The balance in the bank credit facility generally fluctuates throughout the year. A theoretical change of 1% in the interest rate on the balance outstanding at August 31, 2003 would result in an approximate \$514 thousand change in net income. We primarily incur debt obligations to support general corporate purposes including capital expenditures and working capital needs. Our long-term debt instruments are typically issued at fixed interest rates. When these debt obligations mature, we may refinance all or a portion of such debt at then-existing market interest rates which may be more or less than the interest rates on the maturing debt.

Commodity price risk arises from the risk of price changes in the propane inventory that we buy and sell. The market price of propane is often subject to volatile changes as a result of supply or other market conditions over which we have no control. In the past, price changes have generally been passed along to our customers to maintain gross margins, mitigating the commodity price risk. In order to help ensure adequate supply sources are available to us during periods of high demand, we at times will purchase significant volumes of propane during periods of low demand, which generally occur during the summer months, at the then current market price, for storage both at our customer service locations and in major storage facilities and for future resale.

*Propane Hedging.* We also attempt to minimize the effects of market price fluctuations for our propane supply by entering into certain financial contracts. In order to manage a portion of our propane price market risk, we use contracts for the forward purchase of propane, propane fixed-price supply agreements and derivative commodity instruments such as price swap and option contracts. The swap instruments are a contractual agreement to exchange obligations of money between the buyer and seller of the instruments as propane volumes during the pricing period are purchased. The swaps are tied to a fixed price bid by the buyer and a floating price determination for the seller based on certain indices at the end of the relevant trading period. We have entered into these swap instruments in the past to hedge the projected propane volumes to be purchased during each of the one-month periods during the projected heating season.

At August 31, 2003, we had no outstanding propane hedges. We continue to monitor propane prices and may enter into additional propane hedges in the future. Inherent in the portfolio from our liquids marketing activities are certain business risks, including market risk and credit risk. Market risk is the risk that the value of the portfolio will change, either favorably or unfavorably, in response to changing market conditions. Credit risk is the risk of loss from nonperformance by suppliers, customers, or financial counter parties to a contract. We take an active role in managing and controlling market and credit risk and have established control procedures, which are reviewed on an ongoing basis. We monitor market risk through a variety of techniques, including routine reporting to senior management. We attempt to minimize credit risk exposure through credit policies and periodic monitoring procedures.

*Liquids Marketing.* We buy and sell derivative financial instruments, which are within the scope of SFAS 133 and that are not designated as accounting hedges. We also enter into energy trading contracts, which are not derivatives, and therefore are not within the scope of SFAS 133. EITF Issue No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities* (EITF 98-10), applied to energy trading



**Table of Contents**

**Index to Financial Statements**

contracts not within the scope of SFAS 133 that were entered into prior to October 25, 2002. The types of contracts we utilize in our liquids marketing segment include energy commodity forward contracts, options and swaps traded on the over-the-counter financial markets. In accordance with the provisions of SFAS 133, derivative financial instruments utilized in connection with our liquids marketing activity are accounted for using the mark-to-market method. Additionally, all energy trading contracts entered into prior to October 25, 2002 were accounted for using the mark-to-market method in accordance with the provisions of EITF 98-10. Under the mark-to-market method of accounting, forwards, swaps, options and storage contracts are reflected at fair value and are shown in the consolidated balance sheet as assets and liabilities from liquids marketing activities. As of August 31, 2002, we adopted the applicable provisions of EITF Issue No. 02-3, *Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities* (EITF 02-3), which requires that gains and losses on derivative instruments be shown net in the statement of operations if the derivative instruments are held for trading purposes. Net realized and unrealized gains and losses from the financial contracts and the impact of price movements are recognized in the statement of operations as liquids marketing revenue. Changes in the assets and liabilities from the liquids marketing activities result primarily from changes in the market prices, newly originated transactions and the timing and settlement of contracts. EITF 02-3 also rescinds EITF 98-10 for all energy trading contracts entered into after October 25, 2002 and specifies certain disclosure requirements. Consequently, we do not apply mark-to-market accounting for any contracts entered into after October 25, 2002 that are not within the scope of SFAS 133. We attempt to balance our contractual portfolio in terms of notional amounts and timing of performance and delivery obligations. However, net unbalanced positions can exist or be established based on management's assessment of anticipated market movements.

The notional amounts and terms of these financial instruments as of August 31, 2003 and 2002 include fixed price payor for 45,000 and 1,180,000 barrels of propane, respectively, and fixed price receiver of 195,000 and 1,076,900 barrels of propane, respectively. Notional amounts reflect the volume of the transactions, but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure our exposure to market or credit risks.

The fair value of the financial instruments related to liquids marketing activities as of August 31, 2003 and 2002 was assets of \$83 thousand and \$2.3 million, respectively, and liabilities of \$80 thousand and \$1.8 million, respectively.

*Sensitivity Analysis.* Estimates related to our liquids marketing activities are sensitive to uncertainty and volatility inherent in the energy commodities markets and actual results could differ from these estimates. A theoretical change of 10% in the underlying commodity value of the liquids marketing contracts would result in an approximate \$345 thousand change in the market value of the contracts as there were approximately 6.3 million gallons of net unbalanced positions at August 31, 2003.

**Table of Contents****Index to Financial Statements**

*Disclosures about Liquids Marketing Activities Accounted for at Fair Value.* The following table summarizes the fair value of our contracts, aggregated by method of estimating fair value of the contracts as of August 31, 2003 and 2002, where settlement had not yet occurred. Our contracts all have a maturity of less than 1 year. The market prices used to value these transactions reflect management's best estimate considering various factors including closing average spot prices for the current and outer months plus a differential to consider time value and storage costs.

| <u>Source of Fair Value</u>               | <u>August 31,</u><br><u>2003</u> | <u>August 31,</u><br><u>2002</u> |
|---|----------------------------------|----------------------------------|
|   | (In thousands)                   |                                  |
| Prices actively quoted                    | \$ 80                            | \$ 1,276                         |
| Prices based on other valuation methods   | 3                                | 1,025                            |
| <b>Assets from liquids marketing</b>      | <b>\$ 83</b>                     | <b>\$ 2,301</b>                  |
| Prices actively quoted                    | \$ 80                            | \$ 669                           |
| Prices based on other valuation methods   |                                  | 1,149                            |
| <b>Liabilities from liquids marketing</b> | <b>\$ 80</b>                     | <b>\$ 1,818</b>                  |
| <b>Unrealized gains</b>                   | <b>\$ 3</b>                      | <b>\$ 483</b>                    |

The following table summarizes the changes in the unrealized fair value of our contracts where settlement had not yet occurred for the fiscal years ended August 31, 2003, 2002 and 2001.

|   | <u>August 31,</u><br><u>2003</u> | <u>August 31,</u><br><u>2002</u> | <u>August 31,</u><br><u>2001</u> |
|---|----------------------------------|----------------------------------|----------------------------------|
|   | (In thousands)                   |                                  |                                  |
| Unrealized gains (losses) in fair value of contracts outstanding at the beginning of the period     | \$ 483                           | \$ (665)                         | \$ 591                           |
| Unrealized gains (losses) recognized at inception of contracts                                      |                                  |                                  |                                  |
| Unrealized gains (losses) recognized as a result of changes in valuation techniques and assumptions |                                  |                                  |                                  |
| Other unrealized gains (losses) recognized during the period  | 850                              | 1,207                            | 250                              |
| Less: Realized gains (losses) recognized during the period  | 1,330                            | 59                               | 1,506                            |
| Unrealized gains (losses) in fair value of contracts outstanding at the end of the period           | \$ 3                             | \$ 483                           | \$ (665)                         |

***Energy Transfer***

Energy Transfer's primary market risk is commodity price risk. Commodity price risk is present in Energy Transfer's inventory and exchange positions, Energy Transfer's forward physical contracts and commodity derivative positions.

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Energy Transfer's inventory and exchange position is generally not material and the imbalances turn over monthly. Inventory imbalances generally arise when actual volumes delivered differ from nominated amounts or due to other timing differences. Energy Transfer attempts to balance its purchases and sales each month to prevent inventory imbalances from occurring and if necessary attempts to clear any imbalance that arises in the following month. As a result, the volumes involved are generally not significant and turn over quickly. Because Energy Transfer believes that the cost approximates the market value at the end of each month, Energy Transfer has adopted a policy of valuing inventory and imbalances at market value at the end of each month.

Energy Transfer enters into forward physical commitments as a convenience to its customers or to take advantage of market opportunities. Energy Transfer generally attempts to mitigate any market exposure to its forward commitments by either entering into offsetting forward commitments or financial derivative positions.

Energy Transfer enters into commodity derivative contracts to manage its exposure to commodity prices for both natural gas and NGLs.

- 72 -



**Table of Contents****Index to Financial Statements**

The following summarizes Energy Transfer's open commodity derivative positions:

| <b>Basis Swaps</b> | <b>Commodity</b> | <b>Notional</b> |                 | <b>Energy Transfer Pays</b> | <b>Energy Transfer Receives</b> | <b>Fair Value</b> |
|--------------------|------------------|-----------------|-----------------|-----------------------------|---------------------------------|-------------------|
|                    |                  | <b>MMBTU</b>    | <b>Maturity</b> |                             |                                 |                   |
| HSC                | Gas              | 6,865,000       | 2003            | Nymex                       | IFERC                           | \$ (250,650)      |
|                    | Gas              | 14,870,000      | 2003            | IFERC                       | Nymex                           | 1,000,713         |
| HSC                | Gas              | 900,000         | 2004            | Nymex                       | IFERC                           | 2,250             |
|                    | Gas              | 450,000         | 2004            | IFERC                       | Nymex                           | (1,125)           |
| Waha               | Gas              | 2,400,000       | 2003            | Nymex                       | IFERC                           | 64,200            |
|                    | Gas              | 7,230,000       | 2003            | IFERC                       | Nymex                           | (325,525)         |
| Waha               | Gas              |                 | 2004            | Nymex                       | IFERC                           |                   |
|                    | Gas              | 1,780,000       | 2004            | IFERC                       | Nymex                           | (62,300)          |
|                    |                  |                 |                 |                             |                                 | <b>\$ 427,563</b> |

| <b>Futures</b> | <b>Commodity</b> | <b>Long/ Short</b> | <b>Notional</b> |                 | <b>Average</b>      |                   |
|----------------|------------------|--------------------|-----------------|-----------------|---------------------|-------------------|
|                |                  |                    | <b>MMBTU</b>    | <b>Maturity</b> | <b>Strike Price</b> | <b>Fair Value</b> |
|                | Gas              | Long               | 3,085,000       | 2003            | \$ 4.979            | \$ (52,970)       |
|                | Gas              | Short              | 5,910,000       | 2003            | \$ 5.039            | 533,865           |
|                | Gas              | Short              | 60,000          | 2004            | \$ 5.285            | 7,480             |
|                | Gas              | Long               | 30,000          | 2004            | \$ 5.257            | (2,890)           |
|                |                  |                    |                 |                 |                     | <b>\$ 485,485</b> |

Energy Transfer is exposed to market risk for changes in interest rates related to its term note. An interest rate swap agreement is used to manage a portion of the exposure to changing interest rates by converting floating rate debt to fixed-rate debt. The interest rate swap has a notional value of \$75 million and is tied to the maturity of the term note. Under the terms of the interest rate swap agreement, Energy Transfer pays a fixed rate of 2.76% and receives three-month LIBOR. Management has elected not to designate the swap as a hedge for accounting purposes. The fair value of the interest rate swap at August 31, 2003 is a liability of \$807,000 and has been recognized as a component of interest expense.

Unrealized gains recognized in earnings related to Energy Transfer's commodity derivative activities were \$912,000 for the 11 months ended August 31, 2003. The realized losses on commodity derivatives, which were included in revenue, for the 11 months ended August 31, 2003, were \$2,001,000. Realized losses on the interest rate swap included in interest expense were \$312,000.

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Management believes that many of its derivatives positions would qualify as hedges if management had designated them as such for accounting purposes. Had Energy Transfer designated its derivatives as hedges for accounting purposes, a substantial portion of the fair value of its derivatives at August 31, 2003 would not have been recognized through earnings.

*Credit Risk.* Energy Transfer is diligent in attempting to ensure that it issues credit only to credit-worthy counterparties. However, its purchase and resale of gas exposes Energy Transfer to significant credit risk because the margin on any sale is generally a very small percentage of the total sales price. Therefore, a credit loss can be very large relative to Energy Transfer's overall profitability. Historically, Energy Transfer's credit losses have not been significant.

- 73 -

**Table of Contents**

**Index to Financial Statements**

**BUSINESS**

**Overview**

We are one of the ten largest publicly traded master limited partnerships in the United States. We are engaged in the natural gas midstream business through our operating subsidiary, La Grange Acquisition, L.P., and a retail marketer of propane in the United States through our operating subsidiary, Heritage Operating, L.P. We are a publicly traded Delaware limited partnership formed in conjunction with our initial public offering as Heritage Propane Partners, L.P. in June of 1996. Following the completion of our transaction in January 2004, in which we combined the retail propane operations of Heritage Propane Partners with the natural gas midstream operations of Energy Transfer Company, we changed our name to Energy Transfer Partners, L.P.

Through La Grange Acquisition, a Texas limited partnership formed in October 2002, our midstream operations are conducted under the name Energy Transfer Company. Energy Transfer Company's operations are concentrated in the Austin Chalk trend of southeast Texas, the Anadarko Basin of western Oklahoma and the Permian Basin of west Texas. Through our ownership of the Energy Transfer Company operations, we own or have an interest in approximately 4,500 miles of natural gas gathering and transportation pipelines, three natural gas processing plants connected to our gathering systems and seven natural gas treating facilities.

Energy Transfer Company's operations are divided into two business segments, consisting of the midstream segment and the transportation segment. The midstream segment operations are conducted primarily in the Southeast Texas System and the Elk City System, and focus on the gathering of natural gas from over 1,400 producing wells, the compression of natural gas to facilitate its flow through Energy Transfer Company's gathering systems, the treating of natural gas to remove impurities to ensure that the natural gas meets pipeline quality specifications, the processing of natural gas to extract natural gas liquids, and the marketing of natural gas and natural gas liquids to third parties. Our transportation segment focuses on the transportation of natural gas through the Oasis Pipeline, a 583 mile natural gas pipeline that directly connects the Waha Hub, a major natural gas market center located in the Permian Basin of west Texas to the Katy Hub, a major natural gas market center near Houston, Texas.

Through Heritage Operating, we are the fourth largest retail propane marketer in the United States, serving more than 650,000 customers from over 300 customer service locations in 31 states. Our propane operations extend from coast to coast, with concentrations in the western, upper midwestern, northeastern and southeastern regions of the United States. Volumes of propane sold to retail customers have increased steadily from 63.2 million gallons for the fiscal year ended August 31, 1992, to 375.9 million gallons for the fiscal year ended August 31, 2003.

***Energy Transfer Company***

Energy Transfer Company is a growth-oriented midstream natural gas company with operations primarily located in major natural gas producing regions of Texas and Oklahoma. Its primary assets consist of two large gathering systems in the Gulf Coast area of Texas and western Oklahoma and the Oasis Pipeline, an intrastate natural gas pipeline that runs from the Permian Basin in west Texas to natural gas supply and market areas in southeast Texas.

Energy Transfer Company owns or has an interest in over 3,850 miles of natural gas pipeline systems, three natural gas processing plants connected to its gathering systems with a total processing capacity of

- 74 -

**Table of Contents**

**Index to Financial Statements**

approximately 400 MMcf/d and seven natural gas treating facilities with a total treating capacity of approximately 425 MMcf/d.

Energy Transfer Company divides its operations into two primary business segments, the Midstream segment, which consists of its natural gas gathering, compression, treating, processing and marketing operations, and the Transportation segment, which consists of the Oasis Pipeline.

- 75 -

**Table of Contents****Index to Financial Statements**

The table set forth below contains certain information regarding the Southeast Texas System, the Elk City System and the Oasis Pipeline.

| Asset                                 | Type                                      | Length<br>(Miles) | Approximate<br>Wells<br>Connected | Throughput<br>Capacity<br>(MMcf/d) | 11 Months Ended                   |                                  |
|---------------------------------------|---|-------------------|-----------------------------------|------------------------------------|-----------------------------------|----------------------------------|
|                                       |   |                   |                                   |                                    | Average<br>Throughput<br>(MMcf/d) | Utilization<br>of<br>Capacity(%) |
| Southeast Texas System<br>(Midstream) | Gathering and transportation<br>pipelines | 2,500             | 1,000                             | 720                                | 260                               | 36                               |
|                                       | Processing facility                       |                   |                                   | 240                                | 95                                | 40                               |
|                                       | Treating facilities                       |                   |                                   | 250                                | 80                                | 32                               |
| Elk City System<br>(Midstream)        | Gathering pipelines                       | 315               | 300                               | 410                                | 170                               | 41                               |
|                                       | Processing facility                       |                   |                                   | 130                                | 95                                | 73                               |
|                                       | Treating facilities                       |                   |                                   | 145                                |                                   |                                  |
| Oasis Pipeline<br>(Transportation)    | Transportation pipeline                   | 583               |                                   | 1,000                              | 830                               | 83                               |

We intend to construct a 78-mile pipeline that will connect natural gas supplies in east Texas to its Katy Pipeline in Grimes County. The Bossier Pipeline will enable producers to transport natural gas to the Katy Hub from the east Texas area. Pipeline capacity is constrained in this area due to the ongoing drilling activity in the Barnett Shale in north central Texas and the Bossier Sand and other formations. Energy Transfer Company has secured contracts with three separate companies to transport natural gas on this pipeline, including a nine-year fee-based contract with XTO Energy, Inc. Under the agreement, XTO Energy is committed to pay for firm capacity rights on the Bossier Pipeline. That commitment gives XTO Energy the right to use capacity averaging 200 MMcf/d. XTO Energy is obligated to pay for those firm capacity rights whether or not the capacity is utilized thus assuring a continuing revenue stream to the pipeline project.

The Bossier Pipeline is scheduled to be completed by mid calendar year 2004. The pipe to be used in the Bossier Pipeline is currently being manufactured and is scheduled to be delivered to Energy Transfer Company in January 2004. Physical construction of the Bossier Pipeline is expected to begin March 1, 2004. In order to complete the Bossier Pipeline, Energy Transfer Company needs to complete its acquisition of all necessary rights of way. Energy Transfer Company has purchased approximately 50% of these rights of way. Energy Transfer Company has an agreement in principle to purchase an additional 20% of the necessary rights of way and is currently negotiating to purchase the remaining rights of way. We anticipate that the Bossier Pipeline will require capital expenditures of approximately \$75 million to complete. Energy Transfer Company has incurred approximately \$1.4 million in capital expenditures associated with the construction of the Bossier Pipeline through November 30, 2003. The timing and cost of the completion of the Bossier Pipeline may be impacted by any unforeseen costs or difficulties associated with the manufacture of the components of the pipeline, the construction of the pipeline or the acquisition or condemnation of the necessary rights of way.

***Heritage Operating***

***Propane Operations.*** We are one of the largest retail propane marketers in the United States, serving more than 650,000 customers from over 300 customer service locations in 31 states. Our operations extend from coast to coast, with concentrations in the western, upper midwestern, northeastern and southeastern regions of the United States. We are also a wholesale propane supplier in the southwestern and southeastern United States and in Canada, the latter through participation in M-P Energy Partnership. M-P Energy Partnership is a Canadian partnership in

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which we own a 60% interest, engaged in wholesale distribution and in supplying our northern U.S. locations. We are a publicly traded Delaware limited partnership formed in conjunction with our initial public offering in June of 1996. Our business has grown primarily through acquisitions of retail propane

- 76 -

**Table of Contents**

**Index to Financial Statements**

operations and, to a lesser extent, through internal growth. Since our inception through August 31, 2003, we have completed 97 acquisitions for an aggregate purchase price of approximately \$675 million. Volumes of propane sold to retail customers have increased steadily from 63.2 million gallons for the fiscal year ended August 31, 1992 to 375.9 million gallons for the fiscal year ended August 31, 2003.

**Business Strategies**

We intend to operate as a diversified, growth-oriented master limited partnership with a focus on increasing the amount of cash available for distribution on each unit. We believe that by pursuing independent operating and growth strategies for our midstream and propane businesses, we will be best positioned to achieve our objectives. We believe that our size will allow us to participate in growth opportunities.

We expect that midstream acquisitions will be the primary focus of our strategy going forward, however, we will also continue to pursue complementary propane acquisitions. We anticipate that the Energy Transfer Company business will provide internal growth projects of greater scale compared to those available in our propane business.

***Midstream and Transportation Business Strategies***

*Growth through acquisitions.* We intend to make strategic acquisitions of midstream assets in our current areas of operation that offer the opportunity for operational efficiencies and the potential for increased utilization and expansion of its existing and acquired assets. We will also pursue midstream asset acquisition opportunities in other regions of the U.S. with significant natural gas reserves and high levels of drilling activity or with growing demand for natural gas. We believe we will be well positioned to benefit from the additional acquisition opportunities likely to arise as a result of the ongoing divestiture of midstream assets by large industry participants.

*Enhance profitability of existing assets.* We intend to increase the profitability of our existing asset base by adding new volumes of natural gas, undertaking additional initiatives to enhance utilization and reducing costs by improving operations. Recently we have increased the profitability of our assets by:

continuing to add new volumes of natural gas gathered in west Texas under long-term producer commitments and transporting such natural gas on the Oasis Pipeline;

increasing fee-based revenues and enhancing utilization by moving an idle 145 MMcf/d treating facility from the Southeast Texas System to the Elk City System to take advantage of additional natural gas volumes;

reducing operating costs by blending untreated natural gas from the Southeast Texas System with gas on the Oasis Pipeline to meet pipeline quality specifications, which permitted us to shut down treating facilities in the Southeast Texas System; and

reducing operating costs by relocating an existing compressor to the inlet side of the La Grange processing plant, which permitted us to shut down 13 compressors in the Southeast Texas System.





**Table of Contents**

**Index to Financial Statements**

*Engage in construction and expansion opportunities.* We intend to leverage our existing infrastructure and customer relationships by constructing and expanding systems to meet new or increased demand for midstream services. These projects include expansion of existing systems, such as the Bossier Pipeline in east Texas, and construction of new facilities. Once completed, we expect that the Bossier Pipeline will lead to additional growth opportunities in this area.

*Increase cash flow from fee-based businesses.* We generated approximately 46% of our gross margin during the 11 months ended August 31, 2003 from fees charged for providing midstream services, including a transportation fee Energy Transfer Company charges its producer services business for natural gas that it transports on the Oasis Pipeline equal to the fee charged to third parties. This transportation fee accounted for 7% of total gross margin for this period. These fee-based services are dependent on throughput volume and are typically less affected by short-term changes in commodity prices. We intend to seek to increase the percentage of our midstream business conducted with third parties under fee-based arrangements in order to reduce exposure to changes in the prices of natural gas and NGLs. For example, we expect the fee-based contracts associated with the Bossier Pipeline to significantly increase the fee-based component of our gross margin.

***Propane Business Strategies***

*Growth through complementary acquisitions.* We believe that our position as one of the largest propane marketers provides us a solid foundation to continue our acquisition growth strategy through consolidation. We believe that the fragmented nature of the propane industry will continue to provide opportunities for growth through the acquisition of propane businesses that complement our existing asset base. In addition to focusing on propane acquisition candidates in our existing areas of operations, we will also consider core acquisitions in other higher-than-average population growth areas in which we have no presence in order to further reduce the impact adverse weather patterns and economic downturns in any one region may have on our overall operations.

*Maintain low-cost, decentralized operations.* We focus on controlling costs, and we attribute our low overhead costs primarily to our decentralized structure. By delegating all customer billing and collection activities to the customer service location level, as well as delegating other responsibilities to the operating level, we have been able to operate without a large corporate staff. In addition, our customer service location level incentive compensation program encourages employees at all levels to control costs while increasing revenues.

*Pursue internal growth opportunities.* In addition to pursuing expansion through acquisitions, we have aggressively focused on high return internal growth opportunities at our existing customer service locations. We believe that by concentrating our operations in areas experiencing higher-than-average population growth we are well positioned to achieve internal growth by adding new customers.

**Table of Contents**

**Index to Financial Statements**

**Competitive Strengths**

We believe that we are well positioned to compete in both the natural gas midstream and propane industries based on the following strengths:

***Midstream Business Strengths***

*We have a significant market presence in major natural gas supply areas.* We have a significant market presence in each of our operating areas, which are located in major natural gas producing regions of the United States.

*Our Southeast Texas System has additional capacity, which provides opportunities for higher levels of utilization.* We expect to connect new supplies of natural gas volumes by utilizing the available capacity on the Southeast Texas System. The available capacity also provides us with opportunities to extend the Southeast Texas System to additional natural gas producing areas, such as east Texas through the recently announced Bossier Pipeline project.

*Our assets provide marketing flexibility through our access to numerous markets and customers.* Our Oasis Pipeline combined with its Southeast Texas System provides our customers direct access to the Waha and Katy Hubs and to virtually all other market areas in the United States via interconnections with major intrastate and interstate natural gas pipelines. Furthermore, our Oasis Pipeline is tied directly or indirectly to a number of major power generation facilities in Texas as well as several industrial and utility end-users. Additionally, our Elk City System has direct access to six major intrastate and interstate pipelines.

*Our ability to bypass its La Grange and Elk City processing plants reduces our commodity price risk.* A significant benefit of our ownership of the Oasis Pipeline is that we can elect not to process natural gas at our La Grange processing plant when processing margins (or the difference between NGL sales prices and the cost of natural gas) are unfavorable. Instead of processing the natural gas, we are able to deliver natural gas meeting pipeline quality specifications by blending rich gas, or gas with a high NGL content, from the Southeast Texas System with lean gas, or gas with a low NGL content, transported on the Oasis Pipeline. This enables us to sell the blended natural gas for a higher price than we would have been able to realize upon the sale of NGLs if we had to process the natural gas to extract NGLs. In addition, we also have the option to not process natural gas at its Elk City processing plant because the gas produced in this area meets pipeline quality specifications without processing.

***Propane Business Strengths***

*Experience in identifying, evaluating and completing acquisitions.* Since inception through August 31, 2003, we completed 97 propane acquisitions. We follow a disciplined acquisition strategy that concentrates on propane companies that (1) are located in geographic areas experiencing higher-than-average population growth, (2) provide a high percentage of sales to residential customers, (3) have a strong reputation for quality service, and (4) own a high percentage of the propane tanks used by their customers. In addition we attempt to capitalize on the reputations of the companies we acquire by maintaining local brand names, billing practices and employees, thereby creating a sense of continuity and minimizing customer loss. We believe that this strategy has helped to make us an attractive buyer for many propane acquisition candidates from the seller's viewpoint.

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*Geographically diverse retail propane network.* We believe our geographically diverse network of retail propane assets reduces our exposure to unfavorable weather patterns and economic downturns in any one geographic region, thereby reducing the volatility of our cash flows.

- 79 -

**Table of Contents**

**Index to Financial Statements**

*Operations that are focused in areas experiencing higher-than-average population growth.* We believe that our concentration in higher-than-average population growth areas provides a strong economic foundation for expansion through acquisitions and internal growth. We do not believe that we are more vulnerable than our competitors to displacement by natural gas distribution systems because the majority of our areas of operations are located in rural areas where natural gas is not readily available.

*Low-cost administrative infrastructure.* We are dedicated to maintaining a low-cost operating profile and have a successful track record of aggressively pursuing opportunities to reduce costs. Of the 2,418 full-time employees as of August 31, 2003, only 92, or approximately 4%, were general and administrative.

*Decentralized operating structure and entrepreneurial workforce.* We believe that our decentralized operations foster an entrepreneurial corporate culture by: (1) having operational decisions made at the customer service location and operating level, (2) retaining billing, collection and pricing responsibilities at the local and operating level, and (3) rewarding employees for achieving financial targets at the local level.

**Midstream Natural Gas Industry Overview**

The midstream natural gas industry is the link between the exploration and production of natural gas and the delivery of its components to end-use markets and consists of natural gas gathering, compression, treating, processing and transportation and NGL fractionation and transportation. The midstream industry is generally characterized by regional competition based on the proximity of gathering systems and processing plants to natural gas producing wells.

The following diagram illustrates the natural gas gathering, compression, treating, processing, fractionation and transportation processes.

(GRAPH)

*Demand for natural gas.* Natural gas continues to be a critical component of energy consumption in the United States. According to the Energy Information Administration, or the EIA, total domestic consumption of natural gas is expected to increase by over 2.2% per annum, on average, to 27.1 Tcf by 2010, from an estimated 22.2 Tcf consumed in 2001, representing approximately 25% of all total end-user energy requirements by 2010. During the last five years, the United States has on average consumed approximately 22.6 Tcf per year, with average domestic production of approximately 19.1 Tcf per year during the same period. The industrial and electricity generation sectors currently account for the largest usage of natural gas in the United States.

*Natural gas reserves and production.* As of December 31, 2001, operators in the United States had 183.5 Tcf of proved lean natural gas reserves and 191.7 Tcf of proved rich natural gas reserves. Natural gas is described as lean or rich depending on its content of heavy components or liquids content. These are relative terms, but as generally used, rich gas may contain as much as five to six gallons or more of NGLs per Mcf, whereas lean gas usually contains less than one gallon of NGLs per Mcf. Driven by growth in natural gas demand, the EIA projects that domestic natural gas production is projected to increase from 19.7 Tcf per year to 21.9 Tcf per year between 2001 and 2010. According to the EIA, in 2001, Texas, Louisiana and Oklahoma represented the first, second and fourth largest states, respectively, in terms of domestic natural gas production.



**Table of Contents**

**Index to Financial Statements**

*Natural gas gathering.* The natural gas gathering process begins with the drilling of wells into gas bearing rock formations. Once a well has been completed, the well is connected to a gathering system. Gathering systems generally consist of a network of small diameter pipelines and, if necessary, compression systems that collect natural gas from points near producing wells and transport it to larger pipelines for further transportation.

*Natural gas compression.* Gathering systems are operated at design pressures that will maximize the total throughput from all connected wells. Specifically, lower pressure gathering systems allow wells, which produce at progressively lower field pressures as they age, to remain connected to gathering systems and continue to produce for longer periods of time. As the pressure of a well declines, it becomes increasingly more difficult to deliver the remaining production in the ground against a higher pressure that exists in the connecting gathering system. Field compression is typically used to lower the pressure of a gathering system. If field compression is not installed, then the remaining production in the ground will not be produced because it cannot overcome the higher gathering system pressure. In contrast, if field compression is installed, then a well can continue delivering production that otherwise would not be produced.

*Natural gas treating.* Natural gas has a varied composition depending on the field, the formation and the reservoir from which it is produced. Natural gas from certain formations is high in carbon dioxide, hydrogen sulfide or certain other contaminants. Treating plants remove carbon dioxide and hydrogen sulfide from natural gas to ensure that it meets pipeline quality specifications.

*Natural gas processing.* Some natural gas produced by a well does not meet pipeline quality specifications or is not suitable for commercial use and must be processed to remove the mixed NGL stream. In addition, some natural gas produced by a well, while not required to be processed, can be processed to take advantage of favorable processing margins. Natural gas processing involves the separation of natural gas into pipeline quality natural gas, or residue gas, and a mixed NGL stream.

*Natural gas fractionation.* NGL fractionation facilities separate mixed NGL streams into discrete NGL products: ethane, propane, isobutane, normal butane and natural gasoline. Ethane is primarily used in the petrochemical industry as feedstock for ethylene, one of the basic building blocks for a wide range of plastics and other chemical products. Isobutane is fractionated from mixed butane (a stream of normal butane and isobutane in solution) or refined from normal butane through the process of isomerization, principally for use to enhance the octane content of motor gasoline. Normal butane is used as a petrochemical feedstock in the production of ethylene and butadiene (a key ingredient in synthetic rubber), as a blendstock for motor gasoline and to derive isobutane through isomerization. Natural gasoline, a mixture of pentanes and heavier hydrocarbons, is used primarily as motor gasoline blend stock or petrochemical feedstock. Energy Transfer Company does not own or operate fractionation facilities.

*Natural gas transportation.* Natural gas transportation pipelines receive natural gas from other mainline transportation pipelines and gathering systems and deliver the natural gas to industrial end-users, utilities and other pipelines.

**Propane Industry Overview**

Propane, a by-product of natural gas processing and petroleum refining, is a clean-burning energy source recognized for its transportability and ease of use relative to alternative forms of stand-alone energy sources.





**Table of Contents**

**Index to Financial Statements**

Retail propane use falls into three broad categories: (i) residential applications, (ii) industrial, commercial and agricultural applications and (iii) other retail applications, including motor fuel sales. Residential customers use propane primarily for space and water heating. Industrial customers use propane primarily as fuel for forklifts, stationary engines, furnaces, as a cutting gas, in mining operations and in other process applications. Commercial customers, such as restaurants, motels, laundries and commercial buildings, use propane in a variety of applications, including cooking, heating and drying. In the agricultural market, propane is primarily used for tobacco curing, crop drying, poultry brooding and weed control. Other retail uses include motor fuel for cars and trucks, outdoor cooking and other recreational uses, propane resales and sales to state and local governments. In its wholesale operations, we sell propane principally to large industrial end-users and other propane distributors.

Propane is extracted from natural gas at processing plants or separated from crude oil during the refining process. Propane is normally transported and stored in a liquid state under moderate pressure or refrigeration for ease of handling in shipping and distribution. When the pressure is released or the temperature is increased, it is usable as a flammable gas. Propane is naturally colorless and odorless. An odorant is added to allow its detection. Like natural gas, propane is a clean burning fuel and is considered an environmentally preferred energy source.

Propane competes with other sources of energy, some of which are less costly for equivalent energy value. We compete for customers against suppliers of electricity, natural gas and fuel oil. Competition from alternative energy sources has been increasing as a result of reduced utility regulation. Except for certain industrial and commercial applications, propane is generally not competitive with natural gas in areas where natural gas pipelines already exist because natural gas is a significantly less expensive source of energy than propane. The gradual expansion of the nation's natural gas distribution systems has resulted in the availability of natural gas in many areas that previously depended upon propane. Although the extension of natural gas pipelines tends to displace propane distribution in areas affected, we believe that new opportunities for propane sales arise as more geographically remote neighborhoods are developed. Even though propane is similar to fuel oil in certain applications and market demand, propane and fuel oil compete to a lesser extent primarily because of the cost of converting from one to another. Based upon industry publications, propane accounts for three to four percent of household energy consumption in the United States.

In addition to competing with alternative energy sources, we compete with other companies engaged in the retail propane distribution business. Competition in the propane industry is highly fragmented and generally occurs on a local basis with other large multi-state propane marketers, thousands of smaller local independent marketers and farm cooperatives. Most of our customer service locations compete with five or more marketers or distributors. Each retail distribution outlet operates in its own competitive environment because retail marketers tend to locate in close proximity to customers. The typical retail distribution outlet generally has an effective marketing radius of approximately 50 miles although in certain rural areas the marketing radius may be extended by satellite locations.

The ability to compete effectively further depends on the reliability of service, responsiveness to customers and the ability to maintain competitive prices. We believe that our safety programs, policies and procedures are more comprehensive than many of its smaller, independent competitors and give us a competitive advantage over such retailers. We also believe that our service capabilities and customer responsiveness differentiate us from many of these smaller competitors. Our employees are on call 24-hours-a-day, 7-days-a-week for emergency repairs and deliveries.

**Table of Contents**

**Index to Financial Statements**

The wholesale propane business is highly competitive. For fiscal year 2003, our domestic wholesale operations (excluding M-P Energy Partnership) accounted for only 3.9% of our total gallons sold in the United States and approximately 1% of our gross profit. We do not emphasize wholesale operations, but we believe that limited wholesale activities enhance our ability to supply our retail operations.

**Energy Transfer Company**

***The Midstream Segment***

The Midstream business segment consists of Energy Transfer Company's natural gas gathering, compression, treating, processing and marketing operations. This segment consists of the Southeast Texas System, the Elk City System, certain other assets in east Texas and Louisiana and Energy Transfer Company's marketing business.

***Southeast Texas System***

A map representing the location of the Southeast Texas System is set forth below:

[MAP OF SOUTHEAST TEXAS SYSTEM]

*General.* The Southeast Texas System is a large natural gas gathering system in the Gulf Coast area of Texas, covering 13 counties between Austin and Houston. The system consists of approximately 2,500 miles of natural gas gathering and transportation pipelines, ranging in size from two inches to 30 inches in diameter, the La Grange processing plant and five natural gas treating facilities. The system has a capacity of approximately 720 MMcf/d and average throughput on the system was approximately 260 MMcf/d for the 11 months ended August 31, 2003. Thirty-two compressor stations are located within the system, comprised of 54 units with an aggregate of approximately 42,000 horsepower. Energy Transfer Company recently relocated an existing compressor to the inlet side of the La Grange processing plant, permitting Energy Transfer Company to shut down 13 compressors on the gathering system and lower its operating cost.

The Southeast Texas System includes the Katy Pipeline and the La Grange residue line. Energy Transfer Company's Katy Pipeline is a 55-mile pipeline that connects the Southeast Texas System to the Oasis Pipeline at the Katy Hub and to a third-party storage facility and provides transportation services for gas customers from east and southeast Texas to Katy, Texas. The La Grange residue line connects the outlet side of the La Grange processing plant to the Oasis Pipeline, as well as two natural gas fired power plants.

The La Grange processing plant is a cryogenic natural gas processing plant that processes the rich natural gas that flows through Energy Transfer Company's system to produce residue gas and NGLs. The plant has a processing capacity of approximately 240 MMcf/d. During the 11 months ended August 31, 2003, the facility processed approximately 95 MMcf/d of natural gas and produced approximately 9,000 Bbls/d of NGLs.

The Southeast Texas System also includes five natural gas treating facilities with aggregate capacity of approximately 250 MMcf/d. Energy Transfer Company's treating facilities remove carbon dioxide and hydrogen sulfide from natural gas that is gathered into its system before the natural gas is introduced to transportation pipelines to ensure that it meets pipeline quality specifications. Four of its treating facilities are

- 83 -

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**Table of Contents**

**Index to Financial Statements**

amine treating facilities. The amine treating process involves a continuous circulation of a liquid chemical called amine that physically contacts with the natural gas. Amine has a chemical affinity for hydrogen sulfide and carbon dioxide that allows it to absorb the impurities from the natural gas. Energy Transfer Company's remaining treating facility is a hydrogen sulfide scavenger facility. This facility uses a liquid or solid chemical that reacts with hydrogen sulfide thereby removing it from the natural gas.

*Natural Gas Supply.* Energy Transfer Company currently has approximately 1,000 wells connected to the Southeast Texas System. Approximately 90% of these wells are connected to the western portion of this system, which is located in an area that produces rich natural gas that can be processed and which accounted for approximately 56% of Energy Transfer Company's throughput on the system for the 11 months ended August 31, 2003. Lean natural gas is generally produced on the eastern portion of the system. The natural gas supplied to the Southeast Texas System is generally dedicated to Energy Transfer Company under individually negotiated long-term contracts that provide for the commitment by the producer of all natural gas produced from designated properties. Generally, the initial term of such agreements is three to five years or, in some cases, the life of the lease. However, in almost all cases, the term of these agreements is extended for the life of the reserves. Energy Transfer Company's top two suppliers of natural gas to the Southeast Texas System are Chesapeake Energy Corp. and Anadarko Petroleum Corp., which collectively accounted for approximately 44% of the natural gas supplied to this system for the 11 months ended August 31, 2003. Other suppliers of natural gas to the Southeast Texas System are Clayton Williams, Marathon, Devon Energy Corporation, Duke, Crawford, Stroud and Westport, which represented in the aggregate approximately 38% of the Southeast Texas System's natural gas supply for the 11 months ended August 31, 2003.

Energy Transfer Company continually seeks new supplies of natural gas, both to offset natural declines in production from connected wells and to increase throughput volume. Energy Transfer Company obtains new natural gas supplies in its operating areas by contracting for production from new wells, connecting new wells drilled on dedicated acreage or by obtaining natural gas that has been released from other gathering systems. Although most new wells connected to the Southeast Texas System experience rapid declines in production over the first year or two of production, thereafter they decline at slower rates. Approximately 65% of the natural gas supplied to the Southeast Texas System comes from wells that are older than three years, which are currently not experiencing the rapid declines in production associated with new wells.

*Markets for Sale of Natural Gas and NGLs.* The Southeast Texas System has numerous market outlets for the natural gas that Energy Transfer Company gathers and NGLs that it produces on the system. Through Energy Transfer Company's Katy Pipeline, it transports natural gas to the Katy Hub and has access to all of its interconnecting pipelines. The La Grange residue line is connected to the Oasis Pipeline, as well as the Lower Colorado River Authority Sim Gideon and the Calpine Lost Pines power plants. NGLs from the La Grange processing plant are delivered to the Phillips EZ and Seminole Pipeline Company products pipelines, which are connected to Mont Belvieu, Texas, the largest NGL hub in the United States.

*Elk City System*

A map representing the location of the Elk City System is set forth below:

[MAP OF ELK CITY SYSTEM]

**Table of Contents**

**Index to Financial Statements**

*General.* The Elk City System is located in western Oklahoma and consists of over 315 miles of natural gas gathering pipelines, the Elk City processing plant and the Prentiss treating facility. The gathering system has a capacity of approximately 410 MMcf/d and average throughput was approximately 170 MMcf/d for the 11 months ended August 31, 2003. There are five compressor stations located within the system, comprised of 18 units with an aggregate of approximately 19,000 horsepower.

The Elk City processing plant is a cryogenic natural gas processing plant that processes natural gas on the Elk City System to produce residue gas and NGLs. The plant has a processing capacity of approximately 130 MMcf/d. During the 11 months ended August 31, 2003, the facility processed approximately 95 MMcf/d of natural gas and produced approximately 3,600 Bbls/d of NGLs. Energy Transfer Company's Prentiss treating facility, located in Beckham County, Oklahoma, is an amine treating facility with an aggregate capacity of approximately 145 MMcf/d.

*Natural Gas Supply.* Energy Transfer Company currently has approximately 300 wells connected to the Elk City System. Approximately 80% of these wells are connected to the eastern portion of this system, which is located in an area that produces rich natural gas that can be processed and which accounted for approximately 77% of Energy Transfer Company's throughput on the system for the 11 months ended August 31, 2003. Lean natural gas is generally produced on the western portion of this system. The natural gas supplied to the Elk City System is generally dedicated to Energy Transfer Company under individually negotiated long-term contracts. The term of such agreements will typically extend for one to six years. The primary suppliers of natural gas to the Elk City System are Chesapeake Energy Corp. and Kaiser-Francis Oil Company and its affiliates, which represented approximately 28% and 25%, respectively, of the Elk City System's natural gas supply for the 11 months ended August 31, 2003.

The Elk City System is located in an active drilling area. Certain producers are actively drilling in the Springer, Atoka and Arbuckle formations in western Oklahoma at depths in excess of 15,000 feet. Energy Transfer Company recently moved one of its treating plants from Grimes County, Texas to Beckham County, Oklahoma to treat natural gas produced in the western portion of the system. Energy Transfer Company believes that many of the producers drilling in the area will choose to treat their gas through its new treating plant due to the lack of other competitive alternatives.

*Markets for Sale of Natural Gas and NGLs.* The Elk City processing plant has access to five major interstate and intrastate downstream pipelines including Natural Gas Pipeline Company of America, Panhandle Eastern Pipeline Co., Reliant Gas Transmission, Northern Natural Gas and Enogex. There are also direct connections to Natural Gas Pipeline Company and Oneok in the field area. The NGLs that Energy Transfer Company removes are transported on the Koch Hydrocarbons pipeline and delivered for fractionation into Conway, Kansas, a major market center.

*Other Assets*

In addition to the midstream assets described above, Energy Transfer Company owns or has an interest in assets located in Texas and Louisiana. These assets consist of the following:

*Vantex System.* Energy Transfer Company owns a 50% interest in the Vantex natural gas pipeline, a converted 285 mile oil transport line that runs from near the east Texas town of Van to near the Beaumont, Texas industrial area and has a capacity of approximately 100 MMcf/d of natural gas.



**Table of Contents**

**Index to Financial Statements**

*Rusk County Gathering System.* Energy Transfer Company's Rusk County Gathering System consists of approximately 33 miles of natural gas gathering pipeline located in east Texas with a capacity of approximately 15 MMcf/d of natural gas.

*Whiskey Bay System.* The Whiskey Bay System consists of approximately 60 miles of gathering pipelines and a 30 MMcf/d processing plant located in south Louisiana east of Lafayette.

*Chalkley Transmission System.* Energy Transfer Company's Chalkley Transmission System is a 32 mile natural gas gathering system located in south central Louisiana and has a capacity of 100 MMcf/d of natural gas.

*Producer Services*

Through Energy Transfer Company's producer services operations, it markets on-system gas and attracts other customers by marketing off-system gas. For both on-system and off-system gas, Energy Transfer Company purchases natural gas from natural gas producers and other supply points and sells that natural gas to utilities, industrial consumers, other marketers and pipeline companies, thereby generating gross margins based upon the difference between the purchase and resale prices.

Most of Energy Transfer Company's marketing activities involve the marketing of its on-system gas. For the 11 months ended August 31, 2003, Energy Transfer Company marketed approximately 524 MMcf/d of natural gas, 86% of which was on-system gas. Substantially all of Energy Transfer Company's on-system marketing efforts involve natural gas that flows through either the Southeast Texas System or the Oasis Pipeline. Energy Transfer Company markets only a small amount of natural gas that flows through the Elk City System.

For the off-system gas, Energy Transfer Company purchases gas or acts as an agent for small independent producers that do not have marketing operations. Energy Transfer Company develops relationships with natural gas producers to facilitate the purchase of their production on a long-term basis. Energy Transfer Company believes that this business provides Energy Transfer Company with strategic insights and valuable market intelligence which may impact its expansion and acquisition strategy.

During the 11 months ended August 31, 2003, Dow Hydrocarbons and Resources Inc. and Houston Pipe Line Company were Energy Transfer Company's largest producer services customers based on total revenues. During this time period, Energy Transfer Company had gross sales to Dow Hydrocarbons and Resources and Houston Pipe Line as a percentage of total revenues of 18.9% and 11.3%, respectively.

*The Transportation Segment*

A map representing the location of the Oasis Pipeline is set forth below:

[MAP OF OASIS PIPELINE]

*General.* The Oasis Pipeline is a 583-mile, natural gas pipeline that directly connects the Waha Hub in west Texas to the Katy Hub near Houston, Texas. The Oasis Pipeline, constructed in the early 1970 s, is primarily a 36-inch diameter natural gas pipeline. The Oasis Pipeline also has direct connections to three independent

- 86 -



**Table of Contents**

**Index to Financial Statements**

power plants and is connected to two other power plants through the Southeast Texas System. The Oasis Pipeline has bi-directional capability with approximately 1 Bcf/d of natural gas throughput capacity moving west-to-east and greater than 750 MMcf/d of natural gas throughput capacity moving east-to-west. Average throughput was approximately 830 MMcf/d of natural gas for the 11 months ended August 31, 2003. The Oasis Pipeline includes seven mainline compressor stations with approximately 103,000 of installed horsepower.

The Oasis Pipeline is integrated with the Southeast Texas System and is an important component to maximizing the Southeast Texas System's profitability. The Oasis Pipeline enhances the Southeast Texas System:

by providing Energy Transfer Company the ability to bypass the La Grange processing plant when processing margins are unfavorable;

by providing the natural gas on the Southeast Texas System access to other third party supply and market points and interconnecting pipelines; and

by allowing Energy Transfer Company to bypass its treating facilities on the Southeast Texas System and blend untreated gas from the Southeast Texas System with gas on the Oasis Pipeline to meet pipeline quality specifications.

*Markets and Customers.* Energy Transfer Company generally transports natural gas west-to-east on the Oasis Pipeline. The primary receipt points on the Oasis Pipeline are at the Waha Hub, several third party processing plants, the La Grange processing plant through the La Grange residue line and the Katy Hub. The Oasis Pipeline also takes receipt of natural gas from producers at multiple receipt points along the pipeline. The primary delivery points are at the Waha Hub, three independent power plants located mid-system and the Katy Hub. The Waha and Katy Hubs also connect the Oasis Pipeline to pipelines that provide access to substantially all major U.S. market centers.

The Oasis Pipeline's transportation customers include, among others, the independent power plants connected to the pipeline, other major pipelines, natural gas marketers, natural gas producers and other industrial end-users and utilities. The Oasis Pipeline provides direct service to the 1,100 megawatt, or MW, American National Power Hays County power plant, the 1,000 MW Panda Guadalupe Power Partners power plant and the 850 MW Constellation Rio Nogales power plant, all of which are gas-fired, electric generation facilities with a combined maximum natural gas fuel requirement of approximately 480 MMcf/d. In addition, through the La Grange residue line, the Oasis Pipeline provides service to the Lower Colorado River Authority Sim Gideon and the Calpine Lost Pines units, which have a combined maximum natural gas fuel requirement of approximately 240 MMcf/d. These power plants provide electricity for residential, commercial and industrial end-users.

***Competition***

Energy Transfer Company experiences competition in all of its markets. Energy Transfer Company's principal areas of competition include obtaining natural gas supplies for the Southeast Texas System and Elk City System and natural gas transportation customers for the Oasis Pipeline. Energy Transfer Company's competitors include major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas. The Oasis Pipeline competes directly with

## Table of Contents

### Index to Financial Statements

two other major intrastate pipelines that link the Waha Hub and the Houston area, one of which is owned by Duke Energy Field Services and the other one of which is owned by El Paso and American Electric Power Service Corporation. The Southeast Texas System competes with natural gas gathering and processing systems owned by Duke Energy Field Services and Devon Energy Corporation. The Elk City System competes with natural gas gathering and processing systems owned by Enogex, Inc., Oneok Gas Gathering, L.L.C., CenterPoint Energy Field Services, Inc. and Enbridge Inc., as well as producer owned systems.

### **Regulation**

*Regulation by FERC of Interstate Natural Gas Pipelines.* Energy Transfer Company does not own any interstate natural gas pipelines, so FERC does not directly regulate any of Energy Transfer Company's pipeline operations pursuant to its jurisdiction under the NGA. However, FERC's regulation influences certain aspects of Energy Transfer Company's business and the market for Energy Transfer Company's products. In general, FERC has authority over natural gas companies that provide natural gas pipeline transportation services in interstate commerce and its authority to regulate those services includes:

the certification and construction of new facilities;

the extension or abandonment of services and facilities;

the maintenance of accounts and records;

the acquisition and disposition of facilities;

the initiation and discontinuation of services; and

various other matters.

Failure to comply with the NGA can result in the imposition of administrative, civil and criminal remedies.

In recent years, FERC has pursued pro-competitive policies in its regulation of interstate natural gas pipelines. However, we cannot assure you that FERC will continue this approach as it considers matters such as pipelines' rates and rules and policies that may affect rights of access to natural gas transportation capacity.

*Intrastate Pipeline Regulation.* Energy Transfer Company's intrastate natural gas pipeline operations generally are not subject to rate regulation by FERC, but they are subject to regulation by various agencies in Texas, where they are located. However, to the extent that Energy Transfer Company's intrastate pipeline systems transport natural gas in interstate commerce, the rates, terms and conditions of such transportation service are subject to FERC jurisdiction under Section 311 of the NGPA, which regulates, among other things, the provision of transportation services by an intrastate natural gas pipeline on behalf of a local distribution company or an interstate natural gas pipeline. Under Section 311, rates

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charged for transportation must be fair and equitable, and amounts collected in excess of fair and equitable rates are subject to refund with interest. Failure to comply with the NGPA can result in the imposition of administrative, civil and criminal remedies.

Energy Transfer Company's intrastate pipeline operations in Texas are subject to the Texas Utilities Code, as implemented by the TRRC. Generally, the TRRC is vested with authority to ensure that rates, operations and

- 88 -

**Table of Contents**

**Index to Financial Statements**

services of gas utilities, including intrastate pipelines, are just and reasonable and not discriminatory. The TRRC has authority to ensure that rates charged by intrastate pipelines for natural gas sales or transportation services are just and reasonable. The rates Energy Transfer Company charges for transportation services are deemed just and reasonable under Texas law unless challenged in a complaint. We cannot predict whether such a complaint will be filed against Energy Transfer Company or whether the TRRC will change its regulation of these rates. Failure to comply with the Texas Utilities Code can result in the imposition of administrative, civil and criminal remedies.

*Gathering Pipeline Regulation.* Section 1(b) of the NGA exempts natural gas gathering facilities from the jurisdiction of FERC under the NGA. Energy Transfer Company owns a number of natural gas pipelines in Texas, Oklahoma and Louisiana that Energy Transfer Company believes meet the traditional tests FERC has used to establish a pipeline's status as a gatherer not subject to FERC jurisdiction. However, the distinction between FERC-regulated transmission services and federally unregulated gathering services is the subject of substantial, on-going litigation, so the classification and regulation of Energy Transfer Company's gathering facilities are subject to change based on future determinations by FERC and the courts. State regulation of gathering facilities generally includes various safety, environmental and, in some circumstances, nondiscriminatory take requirements and in some instances complaint-based rate regulation.

In Texas, Energy Transfer Company's gathering facilities are subject to regulation by the TRRC under the Texas Utilities Code in the same manner as described above for Energy Transfer Company's intrastate pipeline facilities. Its operations in Oklahoma are regulated by the Oklahoma Corporation Commission through a complaint based procedure. Under the Oklahoma Corporation Commission's regulations, Energy Transfer Company is prohibited from charging any unduly discriminatory fees for its gathering services and in certain circumstances is required to provide open access natural gas gathering for a fee. Louisiana's Pipeline Operations Section of the Department of Natural Resources' Office of Conservation is generally responsible for regulating intrastate pipelines and gathering facilities in Louisiana and has authority to review and authorize natural gas transportation transactions and the construction, acquisition, abandonment and interconnection of physical facilities. Historically, apart from pipeline safety, it has not acted to exercise this jurisdiction respecting gathering facilities. Energy Transfer Company's Chalkley System is regulated as an intrastate transporter, and the Office of Conservation has determined Energy Transfer Company's Whiskey Bay System is a gathering system.

Energy Transfer Company is subject to state ratable take and common purchaser statutes in all of the states in which Energy Transfer Company operates. The ratable take statutes generally require gatherers to take, without undue discrimination, natural gas production that may be tendered to the gatherer for handling. Similarly, common purchaser statutes generally require gatherers to purchase without undue discrimination as to source of supply or producer. These statutes are designed to prohibit discrimination in favor of one producer over another producer or one source of supply over another source of supply. These statutes have the effect of restricting Energy Transfer Company's right as an owner of gathering facilities to decide with whom it contracts to purchase or transport natural gas.

Natural gas gathering may receive greater regulatory scrutiny at both the state and federal levels now that FERC has taken a more light-handed approach to regulation of the gathering activities of interstate pipeline transmission companies and a number of such companies have transferred gathering facilities to unregulated affiliates. For example, the TRRC has approved changes to its regulations governing transportation and gathering services performed by intrastate pipelines and gatherers, which prohibit such entities from unduly

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**Table of Contents**

**Index to Financial Statements**

discriminating in favor of their affiliates. Many of the producing states have adopted some form of complaint-based regulation that generally allows natural gas producers and shippers to file complaints with state regulators in an effort to resolve grievances relating to natural gas gathering access and rate discrimination. Energy Transfer Company's gathering operations could be adversely affected should they be subject in the future to the application of state or federal regulation of rates and services. Energy Transfer Company's gathering operations also may be or become subject to safety and operational regulations relating to the design, installation, testing, construction, operation, replacement and management of gathering facilities. Additional rules and legislation pertaining to these matters are considered or adopted from time to time. We cannot predict what effect, if any, such changes might have on Energy Transfer Company's operations, but the industry could be required to incur additional capital expenditures and increased costs depending on future legislative and regulatory changes.

*Sales of Natural Gas.* Sales for resale of natural gas in interstate commerce made by intrastate pipelines or their affiliates are subject to FERC regulation unless the gas is produced by the pipeline or affiliate. Under current federal rules, however, the price at which Energy Transfer Company sells natural gas currently is not regulated, insofar as the interstate market is concerned and, for the most part, is not subject to state regulation. Effective as of January 12, 2004, the FERC's rules require pipelines (including intrastate pipelines) and their affiliates who sell gas in interstate commerce subject to FERC's jurisdiction to adhere to a code of conduct prohibiting market manipulation and transactions that have no legitimate business purpose or result in prices not reflective of legitimate forces of supply and demand. Those who violate such code of conduct may be subject to suspension or loss of authorization to perform such sales, disgorgement of unjust profits, or other appropriate non-monetary remedies imposed by FERC. FERC denied rehearing of these rules on May 19, 2004 but the rules are still subject to possible court appeals. We cannot predict the outcome of these further proceedings, but do not believe Energy Transfer Company will be affected materially differently from other intrastate gas pipelines and their affiliates. In addition, Energy Transfer Company's sales of natural gas are affected by the availability, terms and cost of pipeline transportation. As noted above, the price and terms of access to pipeline transportation are subject to extensive federal and state regulation. FERC is continually proposing and implementing new rules and regulations affecting those segments of the natural gas industry, most notably interstate natural gas transmission companies, that remain subject to FERC's jurisdiction. These initiatives also may affect the intrastate transportation of natural gas under certain circumstances. The stated purpose of many of these regulatory changes is to promote competition among the various sectors of the natural gas industry and these initiatives generally reflect more light-handed regulation. We cannot predict the ultimate impact of these regulatory changes to Energy Transfer Company's natural gas marketing operations, and Energy Transfer Company notes that some of FERC's more recent proposals may adversely affect the availability and reliability of interruptible transportation service on interstate pipelines. Energy Transfer Company does not believe that it will be affected by any such FERC action materially differently than other natural gas marketers with whom it competes.

*Pipeline Safety.* The states in which Energy Transfer Company conducts operations administer federal pipeline safety standards under the Natural Gas Pipeline Safety Act of 1968, as amended, which requires certain pipelines to comply with safety standards in constructing and operating the pipelines and subjects the pipelines to regular inspections. Failure to comply with the Act may result in the imposition of administrative, civil and criminal remedies. The rural gathering exemption under the Natural Gas Pipeline Safety Act of 1968 presently exempts substantial portions of Energy Transfer Company's gathering facilities from jurisdiction under that statute. The portions of Energy Transfer Company's facilities that are exempt include those portions located outside of cities, towns or any area designated as residential or commercial, such as a subdivision or

## Table of Contents

### Index to Financial Statements

shopping center. The rural gathering exemption, however, may be restricted in the future, and it does not apply to Energy Transfer Company's intrastate natural gas pipelines.

### *Environmental Matters*

The operation of pipelines, plants and other facilities for gathering, compressing, treating, processing, or transporting natural gas, natural gas liquids and other products is subject to stringent and complex laws and regulations pertaining to health, safety and the environment. As an owner or operator of these facilities, Energy Transfer Company must comply with these laws and regulations at the federal, state and local levels. These laws and regulations can restrict or prohibit Energy Transfer Company's business activities that affect the environment in many ways, such as:

restricting the way Energy Transfer Company can release materials or waste products into the air, water, or soils;

limiting or prohibiting construction activities in sensitive areas such as wetlands or areas of endangered species habitat, or otherwise constraining how or when construction is conducted;

requiring remedial action to mitigate pollution from former operations, or requiring plans and activities to prevent pollution from ongoing operations; and

imposing substantial liabilities on Energy Transfer Company for pollution resulting from Energy Transfer Company's operations, including, for example, potentially enjoining the operations of facilities if it were determined that they were not in compliance with permit terms.

In most instances, the environmental laws and regulations affecting Energy Transfer Company's operations relate to the potential release of substances or waste products into the air, water or soils and include measures to control or prevent the release of substances or waste products to the environment. Costs of planning, designing, constructing and operating pipelines, plants and other facilities must incorporate compliance with environmental laws and regulation and safety standards. Failure to comply with these laws and regulations may trigger a variety of administrative, civil and criminal enforcement measures, which can include the assessment of monetary penalties, the imposition of remedial requirements, the issuance of injunctions and federally authorized citizen suits. Moreover, it is not uncommon for neighboring landowners and other third parties to file claims for personal injury and property damage allegedly caused by the release of substances or other waste products to the environment.

The clear trend in environmental regulation is to place more restrictions and limitations on activities that may affect the environment, and thus there can be no assurance as to the amount or timing of future expenditures for environmental compliance or remediation, and actual future expenditures may be different from the amounts Energy Transfer Company currently anticipates. Energy Transfer Company will attempt to anticipate future regulatory requirements that might be imposed and plan accordingly in order to remain in compliance with changing environmental laws and regulations and to minimize the costs of such compliance.

The following is a discussion of certain environmental and safety concerns that relate to the midstream natural gas and NGLs industry. It is not intended to constitute a complete discussion of all applicable federal, state and local laws and regulations, or specific matters, to which Energy Transfer Company may be subject.



**Table of Contents**

**Index to Financial Statements**

Energy Transfer Company's operations are subject to the federal Clean Air Act and comparable state laws and regulations. These laws and regulations govern emissions of pollutants into the air resulting from Energy Transfer Company's activities, for example in relation to Energy Transfer Company's processing plants and its compressor stations, and also impose procedural requirements on how it conducts its operations. Such laws and regulations may include requirements that Energy Transfer Company obtain pre-approval for the construction or modification of certain projects or facilities expected to produce air emissions, strictly comply with the emissions and operational limitations of air emissions permits Energy Transfer Company is required to obtain, or utilize specific equipment or technologies to control emissions. For example, beginning in mid-2004, increased natural gas supplies from the Bossier Pipeline project will likely require the Katy Compressor Station to run one or both of its turbines. The new clean air plan for Houston will require sources of nitrogen oxides or NOx emissions (such as these turbines) to hold allowances for each ton of NOx emitted. Energy Transfer Company currently expects to satisfy this plan requirement between 2004 and 2007 by purchasing annual allowances escalating in cost from \$6,300 in 2004 to \$126,000 in 2007. After 2007, Energy Transfer Company could make a one-time purchase of a perpetual stream of allowances at a currently estimated cost of approximately \$2.3 million. However, rather than simply making a one-time purchase of a large number of perpetual credits, Energy Transfer Company believes that there are less costly alternatives for satisfying this plan requirement, such as the installation of selective catalytic reduction equipment coupled with the one-time purchase of a limited amount of NOx emission reduction credits at a combined currently estimated cost of approximately \$1.3 million. Notwithstanding these current plans, Energy Transfer Company is engaged in negotiations with the Texas Commission on Environmental Quality that could result in the agency granting a variance over a two-year period that would allow Energy Transfer Company to establish a NOx emissions baseline, such that fewer NOx allowances would have to be purchased by Energy Transfer Company. In addition, Energy Transfer Company currently anticipates spending between \$1 million and \$1.5 million prior to 2007 to upgrade its Prairie Lea Compressor Station to comply with recently enacted Texas air permitting regulations. Its failure to comply with these requirements exposes Energy Transfer Company to civil enforcement actions from the state agencies and perhaps the EPA, including monetary penalties, injunctions, conditions or restrictions on operations and potentially criminal enforcement actions or federally authorized citizen suits.

Energy Transfer Company's operations generate wastes, including some hazardous wastes, that are subject to the federal Resource Conservation and Recovery Act ( RCRA ) and comparable state laws. However, RCRA currently exempts many natural gas gathering and field processing wastes from classification as hazardous waste. Specifically, RCRA excludes from the definition of hazardous waste produced waters and other wastes associated with the exploration, development, or production of crude oil, natural gas or geothermal energy. Unrecovered petroleum product wastes, however, may still be regulated under RCRA as solid waste. Moreover, ordinary industrial wastes such as paint wastes, waste solvents, laboratory wastes and waste compressor oils, may be regulated as hazardous waste. The transportation of natural gas and NGLs in pipelines may also generate some hazardous wastes. Although Energy Transfer Company believes it is unlikely that the RCRA exemption will be repealed in the near future, repeal would increase costs for waste disposal and environmental remediation at Energy Transfer Company's facilities.

Energy Transfer Company's operations could incur liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended ( CERCLA ) and comparable state laws regardless of Energy Transfer Company's fault, in connection with the disposal or other release of hazardous substances or wastes, including those arising out of historical operations conducted by Energy Transfer



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**Table of Contents**

**Index to Financial Statements**

Company's predecessors. Although petroleum as well as natural gas and NGLs are excluded from CERCLA's definition of hazardous substance, in the course of its ordinary operations Energy Transfer Company will generate wastes that may fall within the definition of a hazardous substance. CERCLA authorizes the Environmental Protection Agency (the EPA) and, in some cases, third parties to take actions in response to threats to the public health or the environment and to seek to recover from the responsible classes of persons the costs they incur. It is not uncommon for neighboring landowners and other third parties to file claims for personal injury and property damage allegedly caused by hazardous substances or other wastes released into the environment. If Energy Transfer Company was to incur liability under CERCLA, Energy Transfer Company could be subject to joint and several liability for the costs of cleaning up hazardous substances, for damages to natural resources and for the costs of certain health studies.

Energy Transfer Company currently owns or leases, and has in the past owned or leased, numerous properties that for many years have been used for the measurement, gathering, field compression and processing of natural gas and NGLs. Although Energy Transfer Company used operating and disposal practices that were standard in the industry at the time, hydrocarbons or wastes may have been disposed of or released on or under the properties owned or leased by Energy Transfer Company or on or under other locations where such wastes have been taken for disposal. In addition, some of these properties have been operated by third parties whose treatment and disposal or release of hydrocarbons or wastes was not under Energy Transfer Company's control. These properties and the substances disposed or released on them may be subject to CERCLA, RCRA and analogous state laws. Under such laws, Energy Transfer Company could be required to remove or remediate previously disposed wastes (including waste disposed of or released by prior owners or operators) or property contamination (including groundwater contamination, whether from prior owners or operators or other historic activities or spills) or to perform remedial plugging or pit closure operations to prevent future contamination, in some instances regardless of fault or the amount of waste Energy Transfer Company sent to the site. For example, Energy Transfer Company is currently involved in several remediation operations in which Energy Transfer Company's cost for cleanup and related liabilities is estimated to be between \$1.1 million and \$1.8 million in the aggregate. However, with respect to one of the remedial projects, Energy Transfer Company expects to recover approximately \$500,000 to \$850,000 of these estimated cleanup costs pursuant to a contractual requirement that makes a predecessor owner responsible for environmental liabilities. Energy Transfer Company has established environmental accruals totaling approximately \$930,000 to address environmental conditions and related liabilities including costs for cleanup and remediation of properties.

Energy Transfer Company's operations can result in discharges of pollutants to waters. The Federal Water Pollution Control Act of 1972, as amended (FWPCA), also known as the Clean Water Act, and analogous state laws impose restrictions and strict controls regarding the discharge of pollutants into state waters or waters of the United States. The unpermitted discharge of pollutants such as from spill or leak incidents is prohibited. The FWPCA and regulations implemented thereunder also prohibit discharges of fill material and certain other activities in wetlands unless authorized by an appropriately issued permit. Any unpermitted release of pollutants, including NGLs or condensates, from Energy Transfer Company's systems or facilities could result in fines or penalties as well as significant remedial obligations. Energy Transfer Company currently expects to incur costs of approximately \$100,000 over the next year to make spill prevention upgrades or modifications at certain of its facilities as required under its recently updated spill prevention controls and countermeasures or SPCC plans.

Energy Transfer Company's pipelines are subject to regulation by the U.S. Department of Transportation (the DOT) under the Hazardous Liquid Pipeline Safety Act, or HLPESA, pursuant to which the DOT has

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**Table of Contents**

**Index to Financial Statements**

established requirements relating to the design, installation, testing, construction, operation, replacement and management of pipeline facilities. The HLPESA covers crude oil, carbon dioxide, NGL and petroleum products pipelines and requires any entity which owns or operates pipeline facilities to comply with the regulations under the HLPESA, to permit access to and allow copying of records and to make certain reports and provide information as required by the Secretary of Transportation. Energy Transfer Company believes that its pipeline operations are in substantial compliance with applicable HLPESA requirements; however, due to the possibility of new or amended laws and regulations or reinterpretation of existing laws and regulations, there can be no assurance that future compliance with the HLPESA will not have a material adverse effect on Energy Transfer Company's results of operations or financial positions.

Currently, the Department of Transportation, through the Office of Pipeline Safety, is in the midst of promulgating a series of rules intended to require pipeline operators to develop integrity management programs for gas transmission pipelines that, in the event of a failure, could impact high consequence areas. High consequence areas are currently defined as areas with specified population densities, buildings containing populations of limited mobility and areas where people gather that occur along the route of a pipeline. Similar rules are already in place for operators of hazardous liquid pipelines, which are also applicable to Energy Transfer Company's pipelines in certain instances. The Office of Pipeline Safety has yet to publish a final rule requiring gas pipeline operators to develop integrity management plans, but it is expected that a rule will eventually be finalized. Compliance with such rule, or rules, when finalized, could result in increased operating costs that, at this time, cannot reasonably be quantified.

Energy Transfer Company is subject to the requirements of the Occupational Safety and Health Act, referred to as OSHA, and comparable state laws that regulate the protection of the health and safety of workers. In addition, the OSHA hazard communication standard requires that information be maintained about hazardous materials used or produced in Energy Transfer Company's operations and that this information be provided to employees, state and local government authorities and citizens. Energy Transfer Company believes that its operations are in substantial compliance with the OSHA requirements, including general industry standards, record keeping requirements and monitoring of occupational exposure to regulated substances.

Energy Transfer Company does not believe that compliance with federal, state or local environmental laws and regulations will have a material adverse effect on its business, financial position or results of operations. In addition, Energy Transfer Company believes that the various environmental activities in which it does presently engaged are not expected to materially interrupt or diminish its operational ability to gather, compress, treat, process and transport natural gas and NGLs. We cannot assure you, however, that future events, such as changes in existing laws, the promulgation of new laws, or the development or discovery of new facts or conditions will not cause Energy Transfer Company to incur significant costs.

***Title to Properties***

Substantially all of Energy Transfer Company's pipelines are constructed on rights-of-way granted by the apparent record owners of the property. Lands over which pipeline rights-of-way have been obtained may be subject to prior liens that have not been subordinated to the right-of-way grants. Energy Transfer Company has obtained, where necessary, easement agreements from public authorities and railroad companies to cross over or under, or to lay facilities in or along, watercourses, county roads, municipal streets, railroad properties and state highways, as applicable. In some cases, property on which Energy Transfer Company's pipeline was built was purchased in fee.

## **Table of Contents**

### **Index to Financial Statements**

Some of the leases, easements, rights-of-way, permits, licenses and franchise ordinances that will be transferred to Energy Transfer Company will require the consent of the current landowner to transfer these rights, which in some instances is a governmental entity. We believe that Energy Transfer Company has obtained or will obtain sufficient third-party consents, permits and authorizations for the transfer of the assets necessary for Energy Transfer Company to operate its business in all material respects as described in this prospectus supplement. With respect to any consents, permits or authorizations that have not been obtained, we believe that these consents, permits or authorizations will be obtained after the closing of this offering, or that the failure to obtain these consents, permits or authorizations will have no material adverse effect on the operation of Energy Transfer Company's business.

We believe that Energy Transfer Company has satisfactory title to all of its assets. Record title to some of its assets may continue to be held by affiliates of Energy Transfer Company's predecessor until Energy Transfer Company has made the appropriate filings in the jurisdictions in which such assets are located and obtained any consents and approvals that are not obtained prior to transfer. Title to property may be subject to encumbrances. We believe that none of such encumbrances should materially detract from the value of Energy Transfer Company's properties or from its interest in these properties or should materially interfere with their use in the operation of its business.

### ***Office Facilities***

In addition to Energy Transfer Company's gathering and treating facilities discussed above, Energy Transfer Company leases approximately 7,500 square feet of space for Energy Transfer Company's executive offices in Dallas, Texas. Energy Transfer Company also leases office facilities in San Antonio, Texas and Tulsa, Oklahoma, which consist of 39,235 square feet and 1,240 square feet, respectively. While Energy Transfer Company may require additional office space as its business expands, it believes that its existing facilities are adequate to meet its needs for the immediate future and that additional facilities will be available on commercially reasonable terms as needed.

### ***Employees***

To carry out its operations, Energy Transfer Company and its affiliates employs approximately 230 people. Energy Transfer Company is not party to any collective bargaining agreements. Energy Transfer Company considers its employee relations to be good.

### ***Legal Proceedings***

On June 16, 2003, Guadalupe Power Partners, L.P. sought and obtained a Temporary Restraining Order that prevents Oasis Pipe Line from taking action to restrict Guadalupe Power Partners' ability to deliver and receive natural gas under its contract with Oasis Pipe Line at rates of its choice. In their pleadings, Guadalupe Power Partners alleged unspecified monetary damages for the period from February 25, 2003 to June 16, 2003 and sought to prevent Oasis Pipe Line from implementing flow control measures to reduce the flow of gas to their power plant at varying hourly rates. Oasis Pipe Line filed a counterclaim against Guadalupe Power Partners and asked for damages and a declaration that the contract was terminated as a result of the breach by Guadalupe Power Partners. Oasis Pipe Line and Guadalupe Power Partners agreed to a stand still order and referred this dispute to binding arbitration.

**Table of Contents**

**Index to Financial Statements**

Although Energy Transfer Company may, from time to time, be involved in litigation and claims arising out of its operations in the normal course of business, Energy Transfer Company is not currently a party to any material legal proceedings. In addition, Energy Transfer Company is not aware of any material legal or governmental proceedings against Energy Transfer Company, or contemplated to be brought against Energy Transfer Company, under the various environmental protection statutes to which Energy Transfer Company is subject.

**Heritage Operating**

***Products, Services and Marketing***

We distribute propane through a nationwide retail distribution network consisting of over 300 customer service locations in 31 states. Our operations are concentrated in large part in the western, upper midwestern, northeastern and southeastern regions of the United States. We serve more than 650,000 active customers. Historically, approximately two-thirds of our retail propane volumes and in excess of 80% of our EBITDA, as adjusted, were attributable to sales during the six-month peak-heating season from October through March, as many customers use propane for heating purposes. Consequently, sales and operating profits are normally concentrated in the first and second fiscal quarters, while cash flows from operations are generally greatest during the second and third fiscal quarters when customers pay for propane purchased during the six-month peak season. To the extent necessary, we will reserve cash from peak periods for distribution to unitholders during the warmer seasons.

Typically, customer service locations are found in suburban and rural areas where natural gas is not readily available. Generally, such locations consist of a one to two acre parcel of land, an office, a small warehouse and service facility, a dispenser and one or more 18,000 to 30,000 gallon storage tanks. Propane is generally transported from refineries, pipeline terminals, leased storage facilities and coastal terminals by rail or truck transports to our customer service locations where it is unloaded into storage tanks. In order to make a retail delivery of propane to a customer, a bobtail truck is loaded with propane from the storage tank. Propane is then delivered to the customer by the bobtail truck, which generally holds 2,500 to 3,000 gallons of propane, and pumped into a stationary storage tank on the customer's premises. The capacity of these customer tanks ranges from approximately 100 gallons to 1,200 gallons, with a typical tank capacity of 100 to 300 gallons in milder climates and from 500 to 1,000 gallons in colder climates. We also deliver propane to retail customers in portable cylinders, which typically have a capacity of 5 to 35 gallons. When these cylinders are delivered to customers, empty cylinders are picked up for refilling at our distribution locations or are refilled on site. We also deliver propane to certain other bulk end-users of propane in tractor-trailer transports, which typically have an average capacity of approximately 10,500 gallons. End-users receiving transport deliveries include industrial customers, large-scale heating accounts, mining operations and large agricultural accounts.

We encourage our customers whose propane needs are temperature sensitive to implement a regular delivery schedule. Many of our residential customers receive their propane supply pursuant to an automatic delivery system which eliminates the customer's need to make an affirmative purchase decision and allows for more efficient route scheduling. We also sell, install and service equipment related to our propane distribution business, including heating and cooking appliances.

**Table of Contents**

**Index to Financial Statements**

We own, through our subsidiaries, a 60% interest in M-P Energy Partnership, a Canadian partnership that supplies us with propane as described below under Propane Supply and Storage.

Approximately 96% of the domestic gallons we sold in the fiscal year ended August 31, 2003 were to retail customers and 4% were to wholesale customers. Of the retail gallons we sold, 60% were to residential customers, 25% were to industrial, commercial and agricultural customers, and 15% were to other retail users. Sales to residential customers in the fiscal year ended August 31, 2003 accounted for 58% of total domestic gallons sold but accounted for approximately 72% of our gross profit from propane sales. Residential sales have a greater profit margin and a more stable customer base than the other markets we serve. Industrial, commercial and agricultural sales accounted for 18% of our gross profit from propane sales for the fiscal year ended August 31, 2003, with all other retail users accounting for 9%. Additional volumes sold to wholesale customers contributed 1% of our gross profit from propane sales. No single customer accounts for 10% or more of revenues.

The propane business is very seasonal with weather conditions significantly affecting demand for propane. We believe that the geographic diversity of our operations helps to reduce our overall exposure to less than favorable weather conditions in any particular region of the United States. Although overall demand for propane is affected by climate, changes in price and other factors, we believe our residential and commercial business to be relatively stable due to the following characteristics:

residential and commercial demand for propane has been relatively unaffected by general economic conditions due to the largely non-discretionary nature of most propane purchases,

loss of customers to competing energy sources has been low due to the lack of availability or the high cost of alternative fuels,

the tendency of our customers to remain with us due to the product being delivered pursuant to a regular delivery schedule and to our ownership as of August 31, 2003 of 90% of the storage tanks utilized by our customers, which prevents fuel deliveries from competitors, and

our historic ability to more than offset customer losses through internal growth of our customer base in existing markets.

Since home heating usage is the most sensitive to temperature, residential customers account for the greatest usage variation due to weather. Variations in the weather in one or more regions in which we operate can significantly affect the total volumes of propane that we sell and the margins realized thereon and, consequently, our results of operations. We believe that sales to the commercial and industrial markets, while affected by economic patterns, are not as sensitive to variations in weather conditions as sales to residential and agricultural markets.

***Propane Supply and Storage***

Supplies of propane from our sources historically have been readily available. We purchase from over 50 energy companies and natural gas processors at numerous supply points located in the United States and Canada. In the fiscal year ended August 31, 2003, Enterprise Products Operating L.P. ( Enterprise ) and Dynegy Liquids Marketing and Trade ( Dynegy ) provided approximately 29% and 13% of our total propane



**Table of Contents**

**Index to Financial Statements**

supply, respectively. In addition, M-P Oils, Ltd., our wholly owned subsidiary that owns a 60% interest in M-P Energy Partnership, a Canadian partnership, procured 19% of our total propane supply during the fiscal year ended August 31, 2003 through M-P Energy Partnership. M-P Energy Partnership buys and sells propane for its own account and supplies propane to us for our northern United States operations.

We believe that if supplies from Enterprise and Dynegy were interrupted we would be able to secure adequate propane supplies from other sources without a material disruption of our operations. Aside from Enterprise, Dynegy and the supply procured by M-P Oils, Ltd., no single supplier provided more than 10% of our total domestic propane supply during the fiscal year ended August 31, 2003. We believe that our diversification of suppliers will enable us to purchase all of our supply needs at market prices without a material disruption of our operations if supplies are interrupted from any of our existing sources. Although no assurances can be given that supplies of propane will be readily available in the future, we expect a sufficient supply to continue to be available. However, increased demand for propane in periods of severe cold weather, or otherwise, could cause future propane supply interruptions or significant volatility in the price of propane.

We typically enter into one-year supply agreements. The percentage of contract purchases may vary from year to year. Supply contracts generally provide for pricing in accordance with posted prices at the time of delivery or the current prices established at major delivery or storage points, and some contracts include a pricing formula that typically is based on these market prices. Most of these agreements provide maximum and minimum seasonal purchase guidelines. We receive our supply of propane predominately through railroad tank cars and common carrier transport.

Because our profitability is sensitive to changes in wholesale propane costs, we generally seek to pass on increases in the cost of propane to customers. We have generally been successful in maintaining retail gross margins on an annual basis despite changes in the wholesale cost of propane, but there is no assurance that we will always be able to pass on product cost increases fully, particularly when product costs rise rapidly. Consequently, our profitability will be sensitive to changes in wholesale propane prices. See Management's Discussion and Analysis of Financial Condition and Results of Operations Overview.

We lease space in larger storage facilities in New York, Georgia, Michigan, South Carolina, Arizona, New Mexico, Texas, Alberta, Canada and smaller storage facilities in other locations and have the opportunity to use storage facilities in additional locations when we pre-buy product from sources having such facilities. We believe that we have adequate third party storage to take advantage of supply purchasing advantages as they may occur from time to time. Access to storage facilities allows us to buy and store large quantities of propane during periods of low demand, which generally occur during the summer months, or at favorable prices, thereby helping to ensure a more secure supply of propane during periods of intense demand or price instability.

***Pricing Policy***

Pricing policy is an essential element in the marketing of propane. We rely on regional management to set prices based on prevailing market conditions and product cost, as well as local management input. All regional managers are advised regularly of any changes in the posted price of each customer service location's propane suppliers. In most situations, we believe that our pricing methods will permit us to respond to changes in supply costs in a manner that protects our gross margins and customer base, to the extent such protection is possible. In some cases, however, our ability to respond quickly to cost increases could occasionally cause our retail prices to rise more rapidly than those of our competitors, possibly resulting in a loss of customers.





**Table of Contents**

**Index to Financial Statements**

***Billing and Collection Procedures***

Customer billing and account collection responsibilities are retained at the local customer service locations. We believe that this decentralized approach is beneficial for several reasons:

the customer is billed on a timely basis;

the customer is more apt to pay a local business;

cash payments are received more quickly; and

local personnel have a current account status available to them at all times to answer customer inquiries.

***Government Regulation***

We are subject to various federal, state and local environmental, health and safety laws and regulations. Generally, these laws impose limitations on the discharge of pollutants and establish standards for the handling of solid and hazardous wastes. These laws include, without limitation, RCRA, CERCLA, the Clean Air Act, the Occupational Safety and Health Act, the Emergency Planning and Community Right-to-Know Act, the Clean Water Act and comparable state statutes. CERCLA, also known as the Superfund law, imposes joint and several liability in most instances, without regard to fault or the legality of the original conduct, on certain classes of persons that are considered to have contributed to the release or threatened release of a hazardous substance into the environment. Propane is not a hazardous substance within the meaning of CERCLA. However, certain automotive waste products generated by our truck fleet, as well as hazardous substances or hazardous waste disposed of during past operations by third parties on our properties, could subject us to liability under CERCLA. Such laws and regulations could result in civil or criminal penalties in cases of non-compliance and impose liability for remediation costs. In addition, third parties may make claims against owners or operators of properties for personal injuries and property damage associated with releases of hazardous or toxic substances or waste.

In connection with all acquisitions of retail propane businesses that involve the acquisition of any interests in real estate, we conduct an environmental review in an attempt to determine whether any substance other than propane has been sold from, or stored on, any such real estate prior to its purchase. Such review includes questioning the seller, obtaining representations and warranties concerning the seller's compliance with environmental laws and conducting inspections of the properties. Where warranted, independent environmental consulting firms are hired to look for evidence of hazardous substances or the existence of underground storage tanks.

Petroleum-based contamination or environmental wastes are known to be located on or adjacent to six sites, which we presently have or which we or our predecessors formerly had operations. These sites were evaluated at the time of their acquisition. In all cases, remediation operations have been or will be undertaken by others, and in all six cases, we obtained indemnification for expenses associated with any remediation from the former owners or related entities. We have not been named as a potentially responsible party at any of these sites, nor have our operations contributed to the environmental issues at these sites. Accordingly, no amounts have been recorded in our August 31, 2003 or 2002 consolidated balance sheets for any liability that may be attributable to



**Table of Contents**

**Index to Financial Statements**

any required remediation. Based on information currently available to us, such projects are not expected to have a material adverse effect on our financial condition or results of operations.

In July 2001, we acquired a company that had previously received a request for information from the EPA regarding potential contribution to a widespread groundwater contamination problem in San Bernardino, California, known as the Newmark Groundwater Contamination. Although the EPA has indicated that the groundwater contamination may be attributable to releases of solvents from a former military base located within the subject area that occurred long before the facility acquired by us was constructed, it is possible that the EPA may seek to recover all or a portion of groundwater remediation costs from private parties under CERCLA. Based upon information currently available to us, it is not believed that our liability, if such action were to be taken by the EPA, would have a material adverse effect on our financial condition or results of operations.

National Fire Protection Association Pamphlets No. 54 and No. 58, which establish rules and procedures governing the safe handling of propane, or comparable regulations, have been adopted as the industry standard in all of the states in which we operate. In some states these laws are administered by state agencies, and in others they are administered on a municipal level. With respect to the transportation of propane by truck, we are subject to regulations promulgated under the Federal Motor Carrier Safety Act. These regulations cover the transportation of hazardous materials and are administered by the United States Department of Transportation. We conduct ongoing training programs to help ensure that our operations are in compliance with applicable regulations. We maintain various permits that are necessary to operate our facilities, some of which may be material to our operations. We believe that the procedures currently in effect at all of our facilities for the handling, storage, and distribution of propane are consistent with industry standards and are in compliance in all material respects with applicable laws and regulations.

We have implemented environmental programs and policies designed to avoid potential liability and cost under applicable environmental laws. It is possible, however, that we will have increased costs due to stricter pollution control requirements or liabilities resulting from non-compliance with operating or other regulatory permits. It is not anticipated that our compliance with or liabilities under environmental, health and safety laws and regulations, including CERCLA, will have a material adverse effect on us. To the extent that there are any environmental liabilities unknown to us or environmental, health and safety laws or regulations are made more stringent, there can be no assurance that our results of operations will not be materially and adversely affected.

***Employees***

As of August 31, 2003, we had 2,418 full time employees who were employed by our general partner or our subsidiaries, of whom 92 were general and administrative and 2,326 were operational employees. Of our operational employees, 57 are represented by labor unions. Our general partner believes that its relations with its employees are satisfactory. Historically, our general partner has also hired seasonal workers to meet peak winter demands.

**Table of Contents**

**Index to Financial Statements**

*Title to Properties*

We operate bulk storage facilities at nearly 300 customer service locations. We own substantially all of these facilities and have entered into long-term leases for those that we do not own. We believe that the increasing difficulty associated with obtaining permits for new propane distribution locations makes our high level of site ownership and control a competitive advantage. We own approximately 34 million gallons of above ground storage capacity at our various plant sites and have leased an aggregate of approximately 50 million gallons of underground storage facilities in New York, Georgia, Michigan, South Carolina, Arizona, New Mexico, Texas and Alberta, Canada. We do not own or operate any underground storage facilities (excluding customer and local distribution tanks) or propane pipeline transportation assets (other than local delivery systems).

Prior to January 2004, we owned a 50% interest in Bi-State Propane, a California general partnership that conducts business in California and Nevada. Bi-State Propane operates twelve customer service locations that were included on a gross basis in our site, customer and other property descriptions contained herein. However, our 50% interest was accounted for under the equity method. In January 2004, our subsidiary, Heritage Bi-State, L.L.C., acquired 100% of the assets of Bi-State Propane and continues to conduct those operations under the tradename Bi-State Propane.

The transportation of propane requires specialized equipment. The trucks and railroad tank cars used for this purpose carry specialized steel tanks that maintain the propane in a liquefied state. As of August 31, 2003, we utilized approximately 52 transport truck tractors, 50 transport trailers, 12 railroad tank cars, 1,063 bobtails and 1,749 other delivery and service vehicles, all of which we own. As of August 31, 2003, we owned approximately 625,000 customer storage tanks with typical capacities of 120 to 1,000 gallons that are leased or available for lease to customers. These customer storage tanks are pledged as collateral to secure our obligations to our banks and the holders of our notes.

We believe that we have satisfactory title to or valid rights to use all of our material properties. Although some of such properties are subject to liabilities and leases, liens for taxes not yet due and payable, encumbrances securing payment obligations under non-competition agreements and immaterial encumbrances, easements and restrictions, we do not believe that any such burdens will materially interfere with our continued use of such properties in our business, taken as a whole. In addition, we believe that we have, or are in the process of obtaining, all required material approvals, authorizations, orders, licenses, permits, franchises and consents of, and have obtained or made all required material registrations, qualifications and filings with, the various state and local government and regulatory authorities which relate to ownership of our properties or the operations of our business.

We utilize a variety of trademarks and tradenames that we own or have secured the right to use, including Heritage Propane. These trademarks and tradenames have been registered or are pending registration before the United States Patent and Trademark Office or the various jurisdictions in which the marks or tradenames are used. We believe that our strategy of retaining the names of the companies we have acquired has maintained the local identification of these companies and has been important to the continued success of these businesses. Some of our most significant trade names include AGL Propane, Balgas, Bi-State Propane, Blue Flame Gas of Charleston, Blue Flame Gas of Mt. Pleasant, Blue Flame Gas, Carolane Propane Gas, Gas Service Company, EnergyNorth Propane, Gibson Propane, Guilford Gas, Holton's L.P. Gas, Ikard & Newsom, Northern Energy, Sawyer Gas, Peoples Gas Company, Piedmont Propane Company, ProFlame, Rural Bottled Gas and Appliance, ServiGas, V-1 Propane and TECO Propane. We regard our trademarks, tradenames and other proprietary rights as valuable assets and believe that they have significant value in the marketing of our products.

**Table of Contents****Index to Financial Statements*****Legal Proceedings***

Propane is a flammable, combustible gas. Serious personal injury and significant property damage can arise in connection with its storage, transportation or use. In the ordinary course of business, we are sometimes threatened with or are named as a defendant in various lawsuits seeking actual and punitive damages for product liability, personal injury and property damage. We maintain liability insurance with insurers in amounts and with coverages and deductibles we believe are reasonable and prudent, and which are generally accepted in the industry. However, there can be no assurance that the levels of insurance protection currently in effect will continue to be available at reasonable prices or that such levels will remain adequate to protect us from material expenses related to product liability, personal injury or property damage in the future. Of the pending or threatened matters in which we are a party, none have arisen outside the ordinary course of business except for an action filed by us on November 30, 1999, that is currently pending in the Court of Common Pleas, State of South Carolina, Richland County, against SCANA Corporation, Cornerstone Ventures, L.P. and Suburban Propane, L.P. (the "SCANA litigation"). We have asserted under a number of contract and fraud causes of action that SCANA litigation defendants materially breached its contract with us to sell its assets to us and are seeking an unspecified amount of compensatory and punitive damages. The defendants have denied the claims and discovery is ongoing. Although any litigation is inherently uncertain, based on past experience, the information currently available and the availability of insurance coverage, we do not believe that pending or threatened litigation matters will have a material adverse effect on our financial condition or results of operations.

**MANAGEMENT**

The following table sets forth certain information with respect to the executive officers and members of the Board of Directors who held office as of the completion of the Energy Transfer Transaction in January, 2004. Executive officers and directors are elected for one-year terms.

Set forth below is biographical information regarding the foregoing officers and directors of our general partner:

| <b><u>Name</u></b>   | <b><u>Age</u></b> | <b><u>Position with General Partner</u></b>             |
|----------------------|-------------------|---|
| Ray C. Davis         | 61                | Co-Chief Executive Officer and Co-Chairman of the Board |
| Kelcy L. Warren      | 48                | Co-Chief Executive Officer and Co-Chairman of the Board |
| H. Michael Krimbill  | 50                | President and Director                                  |
| R.C. Mills           | 66                | Executive Vice President and Chief Operating Officer    |
| A. Dean Fuller       | 56                | Senior Vice President Operations                        |
| Mackie McCrea        | 44                | Senior Vice President Commercial Development            |
| Bradley K. Atkinson  | 48                | Vice President Corporate Development                    |
| Lon C. Kile          | 48                | Vice President Finance                                  |
| Michael L. Greenwood | 48                | Vice President Finance                                  |
| Stephen L. Cropper   | 53                | Director of the General Partner                         |
| Richard T. O'Brien   | 49                | Director of the General Partner                         |
| J. Charles Sawyer    | 67                | Director of the General Partner                         |
| Bill W. Byrne        | 73                | Director of the General Partner                         |
| David R. Albin       | 44                | Director of the General Partner                         |
| Kenneth A. Hersh     | 40                | Director of the General Partner                         |

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**Table of Contents**

**Index to Financial Statements**

Mr. Darr, Mr. Rose and Mr. Weishahn, executive officers of our general partner at the time of the completion of the Energy Transfer Transaction, continue to hold positions with Heritage Propane Partners or Heritage Operating similar to their positions at that time. Management personnel for Energy Transfer Company at the time of the completion of the Energy Transfer Transaction that are not named in the table above continued to hold similar positions with Energy Transfer Company following the closing of the Energy Transfer Transaction. We have been advised by La Grange Energy that, following the closing of the Energy Transfer Transaction, our general partner will select a chief financial officer after evaluating candidates for the position, who may be officers of our general partner following the closing of the Energy Transfer Transaction as well as other potential candidates. Following the purchase of our general partner by La Grange Energy at the time of the completion of the Energy Transfer Transaction, La Grange Energy obtained the ability, without any approval of our unitholders, to remove any of the directors of the general partner, as well as to add one or more new directors.

Set forth below is biographical information regarding the persons in the foregoing table who became officers and directors of our general partner immediately following the completion of the Energy Transfer Transaction.

*Ray C. Davis.* Mr. Davis is Co-Chief Executive Officer and Co-Chairman of the Board of Directors of our general partner and has served in that capacity since the combination of the operations of Energy Transfer Company and Heritage Propane in January 2004. He has served as Co-Chief Executive Officer of the general partner of La Grange Acquisition since it was formed in 2002. He is Co-Chief Executive Officer and Co-Chairman of the Board of the general partner of La Grange Energy and has served in that capacity since it was formed in 2002. He is also Vice President of the general partner of ET Company I, Ltd., the entity that operated Energy Transfer Company's midstream assets before it acquired Aquila, Inc.'s midstream assets, and has served in that capacity since 1996. From 1996 to 2000, he served as Director of Crosstex Energy, Inc. From 1993 to 1996, he served as Chairman of the board of directors and Chief Executive Officer of Cornerstone Natural Gas, Inc. Mr. Davis has more than 31 years of business experience in the energy industry.

*Kelcy L. Warren.* Mr. Warren is the Co-Chief Executive Officer and Co-Chairman of the Board of our general partner and has served in that capacity since the combination of the operations of Energy Transfer Company and Heritage Propane in January 2004. He has served as Co-Chief Executive Officer of the general partner of La Grange Acquisition since it was formed in 2002. He is Co-Chief Executive Officer and Co-Chairman of the Board of the general partner of La Grange Energy and has served in that capacity since it was formed in 2002. He is also President of the general partner of ET Company I, Ltd., and has served in that capacity since 1996. From 1996 to 2000, he served as Director of Crosstex Energy, Inc. From 1993 to 1996, he served as President, Chief Operating Officer and a director of Cornerstone Natural Gas, Inc. Mr. Warren has more than 20 years of business experience in the energy industry.

*A. Dean Fuller.* Mr. Fuller is a Senior Vice President - Operations of our general partner and has served in that capacity since the combination of the operations of Energy Transfer Company and Heritage Propane in January 2004. He has served as a Senior Vice President and General Manager of the general partner of La Grange Acquisition since it was formed in 2002. From 2000 to 2002, he served as Senior Vice President and General Manager of the midstream business of Aquila, Inc. From 1996 to 2000, he managed the fuel and gas trading operations of Central and South West Corporation, a large electric utility holding company.

**Table of Contents**

**Index to Financial Statements**

*Mackie McCrea.* Mr. McCrea is the Senior Vice President – Commercial Development of our general partner and has served in that capacity since the combination of the operations of Energy Transfer Company and Heritage Propane in January 2004. He has served as Senior Vice President Business Development and Producer Services of the general partner of La Grange Acquisition and ET Company I, Ltd. since 1997.

*Lon C. Kile.* Mr. Kile is Vice President – Finance of our general partner. He has served in the capacity of Chief Financial Officer for the general partner of La Grange Acquisition since it was formed in 2002. From 1999 to 2002, he served as President, Chief Operating Officer and a director of Prize Energy Corporation, a public-traded independent exploration and production company. From 1997 to 1999, he served as Executive Vice President of Pioneer Natural Resources Company, an independent oil and gas company.

*David R. Albin.* Mr. Albin is a managing partner of Natural Gas Partners, L.L.C. and has served in that capacity or similar capacities since 1988. Prior to his participation as a founding member of Natural Gas Partners, L.P. in 1988, he was a partner in the \$600 million Bass Investment Limited Partnership. Prior to joining Bass Investment Limited Partnership, he was a member of the oil and gas group in the investment banking division of Goldman, Sachs & Co. Mr. Albin has served as a director of our general partner since February 2004.

*Kenneth A. Hersh.* Mr. Hersh is a managing partner of Natural Gas Partners, L.L.C. and has served in that capacity or similar capacities since 1989. Prior to joining Natural Gas Partners, L.P. in 1989, he was a member of the energy group in the investment banking division of Morgan Stanley & Co. Mr. Hersh has served as a director of our general partner since February 2004.

Mr. David and Mr. Warren own, directly and indirectly, equity interests in La Grange Energy, the entity that purchased all of the limited partnership interests in our general partner, U.S. Propane, L.P., and all of the member interests in the general partner of our general partner, U.S. Propane, L.L.C. In addition, it was anticipated that several members of the existing management of our general partner will be offered the opportunity to acquire equity interests in La Grange Energy or a related entity, either before or after closing of the Energy Transfer Transaction.

Table of ContentsIndex to Financial Statements**RELATED PARTY TRANSACTIONS****Energy Transfer**

The following is a summary of certain transactions between Energy Transfer Company and certain of its other affiliates.

Beginning in 2003 and after the contribution by an affiliate of La Grange Energy of ET Company I to Energy Transfer Company, Energy Transfer Company has been charged rent by an affiliate for office space in Dallas, which is shared with La Grange Energy and Energy Transfer Company Holdings, L.P., an affiliate of La Grange Energy. For the 11 months ended August 31, 2003, the rent charged to Energy Transfer Company was \$90,000. This office building will be contributed to Energy Transfer Company in connection with the Energy Transfer Transaction.

Prior to the Oasis Pipe Line stock redemption and the contribution of ET Company I to Energy Transfer Company, Energy Transfer Company had purchases and sales of natural gas with Oasis Pipe Line and ET Company I in the normal course of business. The following table summarizes these transactions:

|  | <b>October 1, 2002</b>   |
|--|--------------------------|
|  | <b>(Inception)</b>       |
|  | <b>Through</b>           |
|  | <b>December 31, 2002</b> |
|  | <b>(In thousands)</b>    |
| Sales of natural gas to affiliated companies       | \$ 4,488                 |
| Purchases of natural gas from affiliated companies | \$ 3,989                 |
| Transportation expenses                            | \$ 922                   |

During 2003, Energy Transfer Company Texas Pipeline, Ltd, one of Energy Transfer Company's operating partnerships, purchased a compressor, initially ordered by Energy Transfer Group, L.L.C. for \$799,000. Energy Transfer Group is a 66% owned subsidiary of Energy Transfer Company Holdings, L.P. Energy Transfer Group has a contract to provide compression services to a third party for a fixed monthly fee. Proceeds from the contract will be remitted by Energy Transfer Group to Energy Transfer Company Texas Pipeline, Ltd. to provide a 14.6% return on investment for the capital investment made by Energy Transfer Company Texas Pipeline, Ltd. As of August 31, 2003, no fees had been remitted, but income of \$7,000 has been accrued under the contract. In addition, a \$200,000 deposit was made to a third party vendor by Energy Transfer Company Texas Pipeline, Ltd. on behalf of Energy Transfer Group.

Energy Transfer Company also provides payroll services to Energy Transfer Group. As of August 31, 2003, the receivable due from Energy Transfer Group for payroll services was \$146,141.



## Edgar Filing: Energy Transfer Partners, L.P. - Form 424B3

Energy Transfer Company has advanced working capital of \$303,000 to a joint venture partially owned by Energy Transfer Company, affiliates of Energy Transfer Company Holdings, L.P. and others.

ET GP, LLC, the general partner of Energy Transfer Company Holdings, L.P., has a general and administrative services contract to act as an advisor and provide certain general and administrative services to La Grange Energy and its affiliates, including Energy Transfer Company. The general and administrative services that ET GP, LLC provides La Grange Energy and its subsidiaries under this contract include:

General oversight and direction of engineering, accounting, legal and other professional and operational services required for the support, maintenance and operation of the assets used in the Midstream operations; and

The administration, maintenance and compliance with contractual and regulatory requirements.

- 105 -

**Table of Contents**

**Index to Financial Statements**

In exchange for these services, La Grange Energy and its affiliates are required to pay ET GP, LLC a \$500,000 annual fee payable quarterly and pro-rated for any portion of a calendar year. Pursuant to this contract, La Grange Energy and its affiliates were also required to reimburse ET GP, LLC for expenses associated with formation of La Grange Energy and its affiliates and are required to indemnify ET GP, LLC, its affiliates, officers and employees for liabilities associated with the actions of ET GP, LLC, its affiliates, officers, and employees. As a result of the reimbursement provision, La Grange Energy charged Energy Transfer Company \$449,000 for expenses associated with its formation. For the 11 months ended August 31, 2003, Energy Transfer Company was charged \$375,000 under this contract.

This general and administrative services contract was terminated upon the closing of the Energy Transfer Transaction.

**Heritage Propane Partners**

The following updates information previously provided in our Annual Report on Form 10-K for the year ended August 31, 2003.

We have entered into an agreement with TECO Partners, Inc. ( TECO Partners ) whereby TECO Partners will provide services relating to the securing of new propane customers in our Florida regional operations area. TECO Partners is an affiliated company of TECO Propane Ventures, L.L.C., one of the companies owning limited partner interests in our general partner, U.S. Propane, L.P., and member interests in U.S. Propane, L.L.C., the general partner of U.S. Propane, L.P. Under the agreement, TECO Partners receives commissions upon the procuring of new propane customers for us. The terms of the agreement are no less favorable to us than those available from other parties providing similar services. During fiscal year 2003, TECO Partners received commissions of less than \$200,000. In connection with the Energy Transfer Transaction, TECO Propane Ventures, L.L.C. disposed of its interests in our general partner and, as a result, following the closing of that transaction, there was no longer be a related party relationship.

**Table of Contents**

**Index to Financial Statements**

**DESCRIPTION OF UNITS**

Following the completion of the Energy Transfer Transaction, we had outstanding common units, class C units, class D units, class E units and special units. Set forth below is a description of the relative rights and preferences of holders of these classes of units as specified in our partnership agreement, a copy of which is filed as an exhibit to the registration statement of which this prospectus is a part. For a description of the relative rights and preferences of holders of units and our general partner in and to cash distributions, see Cash Distribution Policy. For a general discussion of the expected federal income tax consequences of owning and disposing of common units, see Material Tax Considerations. References in this Description of Units to we, us and our mean Energy Transfer Partners, L.P.

**Common Units**

Our common units are registered under the Securities Exchange Act of 1934 and are listed for trading on the New York Stock Exchange (the NYSE ). Each holder of a common unit is entitled to one vote per unit on all matters presented to the limited partners for a vote except that holders of common units acquired by La Grange Energy in connection with the Energy Transfer Transaction are entitled to vote upon the proposal to change the terms of the class D units and special units in the same proportion as the votes cast by the holders of the common units other than La Grange Energy with respect to this proposal. In addition, if at any time any person or group (other than our general partner and its affiliates) owns beneficially 20% or more of all common units, any common units owned by that person or group may not be voted on any matter and are not considered to be outstanding when sending notices of a meeting of unitholders (unless otherwise required by law), calculating required votes, determining the presence of a quorum or for other similar purposes under our partnership agreement. The common units are entitled to distributions of available cash as described below under Cash Distribution Policy.

As of January 10, 2004, we had 18,533,855 common units outstanding, of which 11,855,574 were held by the public, 4,606,944 are held by our general partner or its affiliates, and 2,071,337 were held by our officers and directors. As of such date, the common units represent an aggregate 98.0% limited partner interest. Our general partner owns an aggregate 2.0% general partner interest in Energy Transfer Partners, L.P.

In connection with the Energy Transfer Transaction, we issued 4,419,177 common units to La Grange Energy and issued 9.2 million common units in the public offering completed in January 2004.

**Class C Units**

In conjunction with the transaction with U.S. Propane and the change of control of our general partner in August 2000, we issued 1,000,000 newly created class C units to Heritage Holdings in conversion of that portion of its incentive distribution rights that entitled it to receive any distribution attributable to the net amount received by us in connection with the settlement, judgment, award or other final nonappealable resolution of specified litigation filed by us prior to the transaction with U.S. Propane, which we refer to as the SCANA litigation. The class C units have a zero initial capital account balance and were distributed by Heritage Holdings to its former stockholders in connection with the transaction with U.S. Propane. Thus, U.S. Propane will not receive any distributions made with respect to the SCANA litigation.

## Edgar Filing: Energy Transfer Partners, L.P. - Form 424B3

All decisions of our general partner relating to the SCANA litigation are determined by a special litigation committee consisting of one or more independent directors of our general partner. As soon as practicable after

- 107 -

**Table of Contents**

**Index to Financial Statements**

the time that we receive any final cash payment as a result of the resolution of the SCANA litigation, the special litigation committee will determine the aggregate net amount of these proceeds distributable by us by deducting from the amounts received all costs and expenses incurred by us and our affiliates in connection with the SCANA litigation and any cash reserves necessary or appropriate to provide for operating expenditures. Until the special litigation committee decides to make this distribution, none of the distributable proceeds will be deemed to be available cash under our partnership agreement. Please read Cash Distribution Policy below for a discussion of available cash. When the special litigation committee decides to distribute the distributable proceeds, the amount of the distribution will be deemed to be available cash and will be distributed as described below under Cash Distribution Policy. The amount of distributable proceeds that would be distributed to holders of incentive distribution rights will instead be distributed to the holders of the class C units, pro rata. We cannot predict whether we will receive any cash payments as a result of the SCANA litigation and, if so, when these distributions might be received.

The class C units do not have any rights to share in any of our assets or distributions upon dissolution and liquidation of our partnership, except to the extent that any such distributions consist of proceeds from the SCANA litigation to which the class C unitholders would have otherwise been entitled. The class C units do not have the privilege of conversion into any other unit and do not have any voting rights except to the extent provided by law, in which case the class C units will be entitled to one vote.

The amount of cash distributions to which the incentive distribution rights are entitled was not increased by the creation of the class C units; rather, the class C units are a mechanism for dividing the incentive distribution rights that Heritage Holdings and its former stockholders would have been entitled to.

**Class D Units**

The class D units generally have voting rights that are identical to the voting rights of the common units, and the class D units vote with the common units as a single class on each matter with respect to which the common units are entitled to vote. Each class D unit will initially be entitled to receive 100% of the quarterly amount distributed on each common unit, for each quarter, provided that the class D units will be subordinated to the common units with respect to the payment of the minimum quarterly distribution for such quarter (and any arrearage in the payment of the minimum quarterly distribution for all prior quarters). We are required, as promptly as practicable following the issuance of the class D units, to submit to a vote of our unitholders a change in the terms of the class D units to provide that each class D unit is convertible into one common unit immediately upon such approval. Holders of the class D units will be entitled to vote upon the proposal to change the terms of the class D units and the special units in the same proportion as the votes cast by the holders of the common units (other than the common units issued to La Grange Energy in connection with the Energy Transfer Transaction) with respect to this proposal. If our unitholders do not approve this change in the terms of the class D units within six months following the closing of the acquisition of Energy Transfer Company, then each class D unit will be entitled to receive 115% of the quarterly amount distributed on each common unit on a pari passu basis with distributions on the common units.

Upon our dissolution and liquidation, each class D unit will initially be entitled to receive 100% of the amount distributed on each common unit, but only after each common unit has received an amount equal to its capital account, plus the minimum quarterly distribution for the quarter, plus any arrearages in the minimum quarterly distribution with respect to prior quarters. If, however, our unitholders do not approve the change in the class D units to make them convertible, then each class D unit will be entitled upon liquidation to receive 115% of the amount distributed to each common unit on a pari passu basis with liquidating distributions on the common units.

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**Table of Contents**

**Index to Financial Statements**

**Class E Units**

In conjunction with our purchase of the capital stock of Heritage Holdings in January 2004, the 4,426,916 common units held by Heritage Holdings were converted into 4,426,916 class E units. The class E units generally do not have any voting rights but are entitled to vote on the proposals to make class D units and special units convertible into common units. These class E units were entitled to aggregate cash distributions equal to 11.1% of the total amount of cash distributed to all unitholders, including the class E unitholders, up to \$2.82 per unit per year. Upon a default under this note, the class E units will be convertible into common units with a market value of \$100 million at the time of such default. Upon our full payment of the promissory note, we plan to leave the class E units in the form described here indefinitely. In the event of our termination and liquidation, the class E units will be allocated 1% of any gain upon liquidation and will be allocated any loss upon liquidation to the same extent as the common units. After the allocation of such amounts, the class E units will be entitled to the balance in their capital accounts, as adjusted for such termination and liquidation. The terms of the class E units were determined in order to provide us with the opportunity to minimize the impact to us of our ownership of Heritage Holdings, including the \$104 million in deferred tax liabilities of Heritage Holdings that we inherited in connection with our purchase of Heritage Holdings. The class E units are treated as treasury stock for accounting purposes because they are owned by our wholly-owned subsidiary, Heritage Holdings. Due to the ownership of the class E units by this corporate subsidiary, the payment of distributions on the class E units will result in annual tax payments by Heritage Holdings at corporate federal income tax rates, which tax payments will reduce the amount of cash that would otherwise be available for distribution to us, as the owners of Heritage Holdings. Because distributions on the class E units will be available to us as the owner of Heritage Holdings, those funds will be available, after payment of taxes, for our general partnership purposes, including to satisfy working capital requirements, for the repayment of outstanding debt and to make distributions to our unitholders. Although the class E units are pledged to secure the \$50 million promissory note payable to the Previous Owners, distributions payable on the class E units are not required to be used to retire such note. Because the class E units are not entitled to receive any allocation of Partnership income, gain, loss, deduction or credit that is attributable to our ownership of Heritage Holdings, such amounts will instead be allocated to our general partner in accordance with its respective interest and the remainder to all unitholders other than the holders of class E units pro rata. In the event that Partnership distributions exceed \$2.82 per unit annually, all such amounts in excess thereof will be available for distribution to unitholders other than the holders of class E units in proportion to their respective interests.

**Special Units**

The special units were issued by us as consideration for the Bossier Pipeline in connection with the Energy Transfer Transaction. The special units generally do not have any voting rights but are entitled to vote on the proposal to change the terms of the special units in the same proportion as the votes cast by the holders of the common units (other than the common units issued to La Grange Energy in connection with the Energy Transfer Transaction) with respect to this proposal, and will not be entitled to share in partnership distributions. We are required, as promptly as practicable following the issuance of the special units, to submit to a vote of our unitholders the approval of the conversion of the special units into common units in accordance with the terms of the special units. Following unitholder approval and upon the Bossier Pipeline becoming commercially operational, which we expect to occur in mid-2004, each special unit will be immediately convertible into one

**Table of Contents**

**Index to Financial Statements**

common unit upon the request of the holder. If the Bossier Pipeline does not become operational by December 1, 2004 and, as a result, XTO Energy exercises rights to acquire the Bossier Pipeline under its transportation contract, the special units will no longer be considered outstanding and will not be entitled to any rights afforded any other of our units. If our unitholders do not approve the conversion of the special units in accordance with their terms prior to the time the Bossier Pipeline becomes commercially operational, then each special unit will be entitled to receive 115% of the quarterly amount distributed on each common unit on a pari passu basis with distributions on common units, unless subsequently converted into common units. Upon our dissolution and liquidation, the special units will be entitled to receive an assignment of the three contracts described in Business Overview Energy Transfer Company relating to the Bossier Pipeline. If, however, our unitholders do not approve the conversion of the special units into common units prior to the time the Bossier Pipeline becomes commercially operational, then each special unit will be entitled to receive 100% of the amount distributed on each common unit on a pari passu basis with liquidating distributions on the common units.

**Issuance of Additional Securities**

Our partnership agreement authorizes us to issue an unlimited number of additional partnership securities and rights to buy partnership securities for the consideration and on the terms and conditions established by our general partner in its sole discretion, without the approval of the unitholders. Any such additional partnership securities may be senior to the common units.

It is possible that we will fund acquisitions through the issuance of additional common units or other equity securities. Holders of any additional common units we issue will be entitled to share equally with the then-existing holders of common units in our distributions of available cash. In addition, the issuance of additional partnership interests may dilute the value of the interests of the then-existing holders of common units in our net assets.

In accordance with Delaware law and the provisions of our partnership agreement, we may also issue additional partnership securities that, in the sole discretion of the general partner, have special voting rights to which the common units are not entitled.

Upon issuance of additional partnership securities, our general partner will be required to make additional capital contributions to the extent necessary to maintain its 2.0% general partner interest in us. Moreover, our general partner will have the right, which it may from time to time assign in whole or in part to any of its affiliates, to purchase common units or other equity securities whenever, and on the same terms that, we issue those securities to persons other than the general partner and its affiliates, to the extent necessary to maintain its percentage interest, including its interest represented by common units, that existed immediately prior to each issuance. The holders of common units will not have preemptive rights to acquire additional common units or other partnership securities.

The following matters require the approval of the majority of the outstanding common units, including the common units owned by the general partner and its affiliates:

a merger of our partnership;

a sale or exchange of all or substantially all of our assets;





**Table of Contents**

**Index to Financial Statements**

dissolution or reconstitution of our partnership upon dissolution;

certain amendments to the partnership agreement;

the transfer to another person of our general partner interest before June 30, 2006 or the incentive distribution rights at any time, except for transfers to affiliates of the general partner or transfers in connection with the general partner's merger or consolidation with or into, or sale of all or substantially all of its assets to, another person; and

the withdrawal of the general partner prior to June 30, 2006 in a manner that would cause the dissolution of our partnership.

The removal of our general partner requires the approval of not less than 66 2/3% of all outstanding units, including units held by our general partner and its affiliates. Any removal is subject to the election of a successor general partner by the holders of a majority of the outstanding common units, including units held by our general partner and its affiliates.

**Amendments to Our Partnership Agreement**

Amendments to our partnership agreement may be proposed only by our general partner. Certain amendments require the approval of a majority of the outstanding common units, including common units owned by the general partner and its affiliates. Any amendment that materially and adversely affects the rights or preferences of any class of partnership interests in relation to other classes of partnership interests will require the approval of at least a majority of the class of partnership interests so affected. Our general partner may make amendments to the partnership agreement without unitholder approval to reflect:

a change in our name, the location of our principal place of business or our registered agent or office;

the admission, substitution, withdrawal or removal of partners;

a change to qualify or continue our qualification as a limited partnership or a partnership in which the limited partners have limited liability or to ensure that neither we nor our operating partnership will be treated as an association taxable as a corporation or otherwise taxed as an entity for federal income tax purposes;

a change that does not affect our unitholders in any material respect;

a change to (i) satisfy any requirements, conditions or guidelines contained in any opinion, directive, order, ruling or regulation of any federal or state agency or judicial authority or contained in any federal or state statute, (ii) facilitate the trading of common units or comply with any rule, regulation, guideline or requirement of any national securities exchange on which the common units are or will be listed for trading, (iii) that is necessary or advisable in connection with action taken by our general partner with respect to subdivision and combination of our securities or (iv) that is required to effect the intent expressed in our partnership agreement;



**Table of Contents**

**Index to Financial Statements**

a change in our fiscal year or taxable year and any changes that are necessary or advisable as a result of a change in our fiscal year or taxable year;

an amendment that is necessary to prevent us, or our general partner or its directors, officers, trustees or agents from being subjected to the provisions of the Investment Company Act of 1940, as amended, the Investment Advisors Act of 1940, as amended, or plan asset regulations adopted under the Employee Retirement Income Security Act of 1974, as amended;

an amendment that is necessary or advisable in connection with the authorization or issuance of any class or series of our securities;

any amendment expressly permitted in our partnership agreement to be made by our general partner acting alone;

an amendment effected, necessitated or contemplated by a merger agreement approved in accordance with our partnership agreement;

an amendment that is necessary or advisable to reflect, account for and deal with appropriately our formation of, or investment in, any corporation, partnership, joint venture, limited liability company or other entity other than our operating partnership, in connection with our conduct of activities permitted by our partnership agreement;

a merger or conveyance to effect a change in our legal form; or

any other amendment substantially similar to the foregoing.

## **Table of Contents**

### **Index to Financial Statements**

#### (i) Withdrawal or Removal of Our General Partner

Our general partner has agreed not to withdraw voluntarily as our general partner prior to June 30, 2006 without obtaining the approval of the holders of a majority of our outstanding common units, excluding those held by our general partner and its affiliates, and furnishing an opinion of counsel stating that such withdrawal (following the selection of the successor general partner) would not result in the loss of the limited liability of any of our limited partners or of the limited partner of our operating partnership or cause us or our operating partnership to be treated as an association taxable as a corporation or otherwise to be taxed as an entity for federal income tax purposes (to the extent not previously treated as such).

On or after June 30, 2006, our general partner may withdraw as general partner without first obtaining approval of any unitholder by giving 90 days' written notice, and that withdrawal will not constitute a violation of our partnership agreement. In addition, our general partner may withdraw without unitholder approval upon 90 days' notice to our limited partners if at least 50% of our outstanding common units are held or controlled by one person and its affiliates other than our general partner and its affiliates.

Upon the voluntary withdrawal of our general partner, the holders of a majority of our outstanding common units, excluding the common units held by the withdrawing general partner and its affiliates, may elect a successor to the withdrawing general partner. If a successor is not elected, or is elected but an opinion of counsel regarding limited liability and tax matters cannot be obtained, we will be dissolved, wound up and liquidated, unless within 90 days after that withdrawal, the holders of a majority of our outstanding units, excluding the common units held by the withdrawing general partner and its affiliates, agree to continue our business and to appoint a successor general partner. Our general partner may not be removed unless that removal is approved by the vote of the holders of not less than two-thirds of our outstanding units, including units held by our general partner and its affiliates, and we receive an opinion of counsel regarding limited liability and tax matters. Any removal of this kind is also subject to the approval of a successor general partner by the vote of the holders of the majority of our outstanding common units, including those held by our general partner and its affiliates.

While our partnership agreement limits the ability of our general partner to withdraw, it allows the general partner interest to be transferred to an affiliate or to a third party in conjunction with a merger or sale of all or substantially all of the assets of our general partner. In addition, our partnership agreement expressly permits the sale, in whole or in part, of the ownership of our general partner. Our general partner may also transfer, in whole or in part, any common units it owns.

### **Liquidation and Distribution of Proceeds**

Upon our dissolution, unless we are reconstituted and continue as a new limited partnership, the person authorized to wind up our affairs (the liquidator) will, acting with all the powers of our general partner that the liquidator deems necessary or desirable in its good faith judgment, liquidate our assets. The proceeds of the liquidation will be applied as follows:

first, towards the payment of all of our creditors and the creation of a reserve for contingent liabilities; and

then, to all partners in accordance with the positive balance in their respective capital accounts.



**Table of Contents**

**Index to Financial Statements**

Under some circumstances and subject to some limitations, the liquidator may defer liquidation or distribution of our assets for a reasonable period of time. If the liquidator determines that a sale would be impractical or would cause a loss to our partners, our general partner may distribute assets in kind to our partners.

**Limited Call Right**

If at any time less than 20% of the outstanding common units of any class are held by persons other than our general partner and its affiliates, our general partner will have the right to acquire all, but not less than all, of those common units at a price no less than their then-current market price. As a consequence, a unitholder may be required to sell his common units at an undesirable time or price. Our general partner may assign this purchase right to any of its affiliates or us.

**Indemnification**

Under our partnership agreement, in most circumstances, we will indemnify our general partner, its affiliates and their officers and directors to the fullest extent permitted by law, from and against all losses, claims or damages any of them may suffer by reason of their status as general partner, officer or director, as long as the person seeking indemnity acted in good faith and in a manner believed to be in or not opposed to our best interest. Any indemnification under these provisions will only be out of our assets. Our general partner shall not be personally liable for, or have any obligation to contribute or loan funds or assets to us to effectuate any indemnification. We are authorized to purchase insurance against liabilities asserted against and expenses incurred by persons for our activities, regardless of whether we would have the power to indemnify the person against liabilities under our partnership agreement.

**Listing**

Our outstanding common units are listed on the NYSE under the symbol HPG. Any additional common units we issue also will be listed on the NYSE.

**Transfer Agent and Registrar**

The transfer agent and registrar for the common units is American Stock Transfer & Trust Company.

**Transfer of Common Units**

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Each purchaser of common units offered by this prospectus must execute a transfer application. By executing and delivering a transfer application, the purchaser of common units:

becomes the record holder of the common units and is an assignee until admitted into our partnership as a substituted limited partner;

automatically requests admission as a substituted limited partner in our partnership;

agrees to be bound by the terms and conditions of, and executes, our partnership agreement;

- 114 -

**Table of Contents**

**Index to Financial Statements**

represents that such person has the capacity, power and authority to enter into the partnership agreement;

grants to our general partner the power of attorney to execute and file documents required for our existence and qualification as a limited partnership, the amendment of the partnership agreement, our dissolution and liquidation, the admission, withdrawal, removal or substitution of partners, the issuance of additional partnership securities and any merger or consolidation of the partnership.

makes the consents and waivers contained in the partnership agreement, including the waiver of the fiduciary duties of the general partner to unitholders as described in Risk Factors Risks Inherent in an Investment in Us Our partnership agreement limits our general partner's fiduciary duties to our unitholders and restricts the remedies available to unitholders for actions taken by our general partner that might otherwise constitute breaches of fiduciary duty.

An assignee will become a substituted limited partner of our partnership for the transferred common units upon the consent of our general partner and the recording of the name of the assignee on our books and records. Although the general partner has no current intention of doing so, it may withhold its consent in its sole discretion. An assignee who is not admitted as a limited partner will remain an assignee. An assignee is entitled to an interest equivalent to that of a limited partner for the right to share in allocations and distributions from us, including liquidating distributions. Furthermore, our general partner will vote and exercise other powers attributable to common units owned by an assignee at the written direction of the assignee.

Transfer applications may be completed, executed and delivered by a purchaser's broker, agent or nominee. We are entitled to treat the nominee holder of a common unit as the absolute owner. In that case, the beneficial holders' rights are limited solely to those that it has against the nominee holder as a result of any agreement between the beneficial owner and the nominee holder.

Common units are securities and are transferable according to the laws governing transfer of securities. In addition to other rights acquired, the purchaser has the right to request admission as a substituted limited partner in our partnership for the purchased common units. A purchaser of common units who does not execute and deliver a transfer application obtains only:

the right to assign the common unit to a purchaser or transferee; and

the right to transfer the right to seek admission as a substituted limited partner in our partnership for the purchased common units.

Thus, a purchaser of common units who does not execute and deliver a transfer application:

will not receive cash distributions or federal income tax allocations, unless the common units are held in a nominee or street name account and the nominee or broker has executed and delivered a transfer application; and

may not receive some federal income tax information or reports furnished to record holders of common units.





**Table of Contents**

**Index to Financial Statements**

Until a common unit has been transferred on our books, we and the transfer agent, notwithstanding any notice to the contrary, may treat the record holder of the unit as the absolute owner for all purposes, except as otherwise required by law or NYSE regulations.

**Status as Limited Partner or Assignee**

Except as described under Limited Liability, the common units will be fully paid, and the unitholders will not be required to make additional capital contributions to us.

**Limited Liability**

Assuming that a limited partner does not participate in the control of our business within the meaning of the Delaware Revised Uniform Limited Partnership Act (the Delaware Act) and that he otherwise acts in conformity with the provisions of our partnership agreement, his liability under the Delaware Act will be limited, subject to possible exceptions, to the amount of capital he is obligated to contribute to us for his common units plus his share of any undistributed profits and assets. If it were determined, however, that the right or exercise of the right by the limited partners as a group:

to remove or replace the general partner;

to approve some amendments to our partnership agreement; or

to take other action under our partnership agreement;

*constituted participation in the control of our business for the purposes of the Delaware Act, then the limited partners could be held personally liable for our obligations under Delaware law, to the same extent as the general partner. This liability would extend to persons who transact business with us and who reasonably believe that the limited partner is a general partner. Neither our partnership agreement nor the Delaware Act specifically provides for legal recourse against our general partner if a limited partner were to lose limited liability through any fault of the general partner. While this does not mean that a limited partner could not seek legal recourse, we have found no precedent for this type of a claim in Delaware case law.*

Under the Delaware Act, a limited partnership may not make a distribution to a partner if after the distribution all liabilities of the limited partnership, other than liabilities to partners on account of their partnership interests and liabilities for which the recourse of creditors is limited to specific property of our partnership, exceed the fair value of the assets of the limited partnership. For the purpose of determining the fair value of the assets of a limited partnership, the Delaware Act provides that the fair value of property subject to liability for which recourse of creditors is limited shall be included in the assets of the limited partnership only to the extent that the fair value of that property exceeds the nonrecourse liability. The Delaware Act provides that a limited partner who receives a distribution and knew at the time of the distribution that the distribution was in violation of the Delaware Act shall be liable to the limited partnership for the amount of the distribution for three years. Under the Delaware Act, an assignee who becomes a substituted limited partner of a limited partnership is liable for the obligations of his assignor to make contributions to our partnership, except the assignee is not obligated for liabilities unknown to him at the time he became a

limited partner and which could not be ascertained from our partnership agreement.

- 116 -

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**Table of Contents**

**Index to Financial Statements**

Our subsidiaries currently conduct business in 29 states: Alabama, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Kentucky, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington and Wyoming. To maintain the limited liability for Heritage Propane Partners, L.P., as the holder of a 98.9899% limited partner interest in Heritage Operating, L.P., we may be required to comply with legal requirements in the jurisdictions in which Heritage Operating, L.P. conducts business, including qualifying our subsidiaries to do business there. Limitations on the liability of limited partners for the obligations of a limited partnership have not been clearly established in many jurisdictions. If it were determined that we were, by virtue of our limited partner interest in Heritage Operating, L.P. or otherwise, conducting business in any state without compliance with the applicable limited partnership statute, or that our right or the exercise of our right to remove or replace Heritage Operating, L.P.'s general partner, to approve some amendments to Heritage Operating, L.P.'s partnership agreement, or to take other action under Heritage Operating, L.P.'s partnership agreement constituted participation in the control of Heritage Operating, L.P.'s business for purposes of the statutes of any relevant jurisdiction, then we could be held personally liable for Heritage Operating, L.P.'s obligations under the law of that jurisdiction to the same extent as our general partner under the circumstances. We will operate in a manner as our general partner considers reasonable and necessary or appropriate to preserve our limited liability.

**Meetings; Voting**

Except as described below regarding a person or group owning 20% or more of any class of units then outstanding, unitholders or assignees who are record holders of units on the record date will be entitled to notice of, and to vote at, meetings of our limited partners and to act upon matters for which approvals may be solicited. Common units that are owned by an assignee who is a record holder, but who has not yet been admitted as a limited partner, shall be voted by our general partner at the written direction of the record holder. Absent direction of this kind, the common units will not be voted, except that, in the case of common units held by our general partner on behalf of non-citizen assignees, our general partner shall distribute the votes on those common units in the same ratios as the votes of limited partners on other units are cast.

Our general partner does not anticipate that any meeting of unitholders will be called in the foreseeable future. Any action that is required or permitted to be taken by the unitholders may be taken either at a meeting of the unitholders or without a meeting if consents in writing describing the action so taken are signed by holders of the number of units as would be necessary to authorize or take that action at a meeting. Meetings of the unitholders may be called by our general partner or by unitholders owning at least 20% of the outstanding units of the class for which a meeting is proposed. Unitholders may vote either in person or by proxy at meetings. The holders of a majority of the outstanding units of the class or classes for which a meeting has been called represented in person or by proxy shall constitute a quorum unless any action by the unitholders requires approval by holders of a greater percentage of the units, in which case the quorum shall be the greater percentage.

Each record holder of a unit has a vote according to his percentage interest in us, although additional limited partner interests having special voting rights could be issued. However, if at any time any person or group, other than our general partner and its affiliates, owns, in the aggregate, beneficial ownership of 20% or more of the common units then outstanding, the person or group will lose voting rights on all of its common units and its common units may not be voted on any matter and will not be considered to be outstanding when sending notices of a meeting of unitholders, calculating required votes, determining the presence of a quorum or for

**Table of Contents**

**Index to Financial Statements**

other similar purposes. Common units held in nominee or street name account will be voted by the broker or other nominee in accordance with the instruction of the beneficial owner unless the arrangement between the beneficial owner and his nominee provides otherwise.

Any notice, demand, request, report or proxy material required or permitted to be given or made to record holders of common units under our partnership agreement will be delivered to the record holder by us or by the transfer agent.

**Books and Reports**

Our general partner is required to keep appropriate books of our business at our principal offices. The books will be maintained for both tax and financial reporting purposes on an accrual basis. Reporting for tax purposes is done on a calendar year basis.

We will furnish or make available to record holders of common units, within 120 days after the close of each fiscal year, an annual report containing audited financial statements and a report on those financial statements by our independent public accountants. Except for our fourth quarter, we will also furnish or make available summary financial information within 90 days after the close of each quarter.

We will furnish each record holder of a unit with information reasonably required for tax reporting purposes within 90 days after the close of each calendar year. This information is expected to be furnished in summary form so that some complex calculations normally required of partners can be avoided. Our ability to furnish this summary information to unitholders will depend on the cooperation of unitholders in supplying us with specific information. Every unitholder will receive information to assist him in determining his federal and state tax liability and filing his federal and state income tax returns, regardless of whether he supplies us with information.

Our partnership agreement provides that a limited partner can, for a purpose reasonably related to his interest as a limited partner, upon reasonable demand and at his own expense, have furnished to him:

a current list of the name and last known address of each partner;

a copy of our tax returns;

information as to the amount of cash, and a description and statement of the agreed value of any other property or services, contributed or to be contributed by each partner and the date on which each became a partner;

copies of our partnership agreement, the certificate of limited partnership of the partnership, related amendments and powers of attorney under which they have been executed;

information regarding the status of our business and financial condition; and

any other information regarding our affairs as is just and reasonable.

- 118 -

**Table of Contents**

**Index to Financial Statements**

Our general partner may, and intends to, keep confidential from the limited partners trade secrets or other information the disclosure of which our general partner believes in good faith is not in our best interests or that we are required by law or by agreements with third parties to keep confidential.

**CASH DISTRIBUTION POLICY**

**Distributions of Available Cash**

References in this Cash Distribution Policy to we, us and our mean Energy Transfer Partners, L.P.

*General.* We will distribute all of our available cash to our unitholders and our general partner within 45 days following the end of each fiscal quarter.

*Definition of Available Cash.* Available cash is defined in our partnership agreement and generally means, with respect to any calendar quarter, all cash on hand at the end of such quarter:

less the amount of cash reserves that are necessary or appropriate in the reasonable discretion of the general partner to:

provide for the proper conduct of our business;

comply with applicable law or any debt instrument or other agreement (including reserves for future capital expenditures and for our future credit needs); or

provide funds for distributions to unitholders and our general partner in respect of any one or more of the next four quarters;

plus all cash on hand on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter. Working capital borrowings are generally borrowings that are made under our credit facilities and in all cases are used solely for working capital purposes or to pay distributions to partners.

**Operating Surplus and Capital Surplus**

*General.* All cash distributed to unitholders will be characterized as either operating surplus or capital surplus. We distribute available cash from operating surplus differently than available cash from capital surplus.

*Definition of Operating Surplus.* Operating surplus for any period generally means:

our cash balance on the closing date of our initial public offering; plus

\$10.0 million (as described below); plus

- 119 -



**Table of Contents**

**Index to Financial Statements**

all of our cash receipts since the closing of our initial public offering, excluding cash from interim capital transactions such as borrowings that are not working capital borrowings, sales of equity and debt securities and sales or other dispositions of assets outside the ordinary course of business; plus

working capital borrowings made after the end of a quarter but before the date of determination of operating surplus for the quarter; less

all of our operating expenditures after the closing of our initial public offering, including the repayment of working capital borrowings, but not the repayment of other borrowings, and including maintenance capital expenditures; less

the amount of cash reserves that the general partner deems necessary or advisable to provide funds for future operating expenditures.

*Definition of Capital Surplus.* Generally, capital surplus will be generated only by:

borrowings other than working capital borrowings;

sales of debt and equity securities; and

sales or other disposition of assets for cash, other than inventory, accounts receivable and other current assets sold in the ordinary course of business or as part of normal retirements or replacements of assets.

*Characterization of Cash Distributions.* We will treat all available cash distributed as coming from operating surplus until the sum of all available cash distributed since we began operations equals the operating surplus as of the most recent date of determination of available cash. We will treat any amount distributed in excess of operating surplus, regardless of its source, as capital surplus. As reflected above, operating surplus includes \$10.0 million in addition to our cash balance on the closing date of our initial public offering, cash receipts from our operations and cash from working capital borrowings. This amount does not reflect actual cash on hand that is available for distribution to our unitholders. Rather, it is a provision that will enable us, if we choose, to distribute as operating surplus up to \$10.0 million of cash we receive in the future from non-operating sources, such as asset sales, issuances of securities, and long-term borrowings, that would otherwise be distributed as capital surplus. We have not made, and we anticipate that we will not make, any distributions from capital surplus.

**Incentive Distribution Rights**

Incentive distribution rights represent the contractual right to receive an increasing percentage of quarterly distributions of available cash from operating surplus after the minimum quarterly distribution has been paid. Please read [Distributions of Available Cash from Operating Surplus](#) below. The general partner owns all of the incentive distribution rights, except that in conjunction with the August 2000 transaction with U.S. Propane, L.P., we issued 1,000,000 class C units to Heritage Holdings, Inc., our general partner at that time, in conversion of that portion of Heritage Holdings, Inc.'s incentive distribution rights that entitled it to receive any distribution made by us of funds attributable to the net amount received by us in connection with the settlement, judgment, award or other final nonappealable resolution of the SCANA litigation. Any amount payable on the class C units in the future will reduce the amount otherwise distributable to holders of incentive distribution



**Table of Contents**

**Index to Financial Statements**

rights at the time the distribution of such litigation proceeds is made and will not reduce the amount distributable to holders of common units. No payments to date have been made on the class C units.

**Distributions of Available Cash from Operating Surplus**

We will make distributions of available cash from operating surplus for any quarter in the following manner:

First, 98% to all common, class D and class E unitholders, in accordance with their percentage interests, and 2% to the general partner, until each common unit has received \$0.50 per unit for such quarter (the minimum quarterly distribution );

Second, 98% to all common, class D and class E unitholders, in accordance with their percentage interests, and 2% to the general partner, until each common unit has received \$0.55 per unit for such quarter (the first target distribution );

Third, 85% to all common, class D and class E unitholders, in accordance with their percentage interests, 13% to the holders of incentive distribution rights, pro rata, and 2% to the general partner, until each common unit has received \$0.635 per unit for such quarter (the second target distribution );

Fourth, 75% to all common, class D and class E unitholders, in accordance with their percentage interests, 23% to the holders of incentive distribution rights, pro rata, and 2% to the general partner, until each common unit has received \$0.825 per unit for such quarter (the third target distribution ); and

Fifth, thereafter, 50% to all common, class D and class E unitholders, in accordance with their percentage interests, 48% to the holders of incentive distribution rights, pro rata, and 2% to the general partner.

Notwithstanding the foregoing, the class D units will be subordinated to the common units with respect to the payment of the minimum quarterly distribution and any arrearage in the payment of the minimum quarterly distribution for all prior quarters and the distributions on each class E unit may not exceed \$2.82 per year. Please read Description of Units for a discussion of the class C units and the percentage interests in distributions of the different classes of units.

If the unitholders do not approve changing the terms of the class D units and special units within six months of the closing of the Energy Transfer Transaction to provide that these units are convertible into common units and the Bossier Pipeline is commercially operational, then we will distribute available cash, excluding any available cash to be distributed to our class C unitholders, as follows:

First, 98% to the common, class D, class E and special unitholders in accordance with their percentage interests, and 2% to our general partner, with each class D and special unit receiving 115% of the amount distributed on each common unit, until each common unit has received \$0.50 for that quarter;

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Second, 98% to all common, class D, class E and special unitholders in accordance with their percentage interests, and 2% to our general partner, with each class D and special unit receiving 115% of the amount distributed on each common unit, until each common unit has received \$0.55 for that quarter;

- 121 -

**Table of Contents**

**Index to Financial Statements**

Third, 85% to all common, class D, class E and special unitholders in accordance with their percentage interests, and 15% to our general partner, with each class D and special unit receiving 115% of the amount distributed on each common unit, until each common unit has received \$0.635 for that quarter;

Fourth, 75% to all common, class D, class E and special unitholders in accordance with their percentage interests, and 25% to our general partner, with each class D and special unit receiving 115% of the amount distributed on each common unit, until each common unit has received \$0.825 for that quarter;

Thereafter, 50% to all common, class D, class E and special unitholders in accordance with their percentage interests, with each class D and special unit receiving 115% of the amount distributed on each common unit, and 50% to our general partner.

Notwithstanding the foregoing, the distributions to the class E unitholders may not exceed \$2.82 per year. Please read [Description of Units](#) for a discussion of the class C units and the percentage interests in distributions of the different classes of units and [Cash Distribution Policy](#) for a more detailed description of our cash distribution policy.

**Distributions of Available Cash from Capital Surplus**

We will make distributions of available cash from capital surplus, if any, in the following manner:

First, 98% to all unitholders, pro rata, and 2% to the general partner, until we distribute for each common unit, an amount of available cash from capital surplus equal to the initial public offering price;

Thereafter, we will make all distributions of available cash from capital surplus as if they were from operating surplus.

Our partnership agreement treats a distribution of capital surplus as the repayment of the initial unit price from the initial public offering, which is a return of capital. The initial public offering price less any distributions of capital surplus per unit is referred to as the [unrecovered capital](#). Each time a distribution of capital surplus is made, the minimum quarterly distribution and the target distribution levels will be reduced in the same proportion as the corresponding reduction in the unrecovered capital. Because distributions of capital surplus will reduce the minimum quarterly distribution, after any of these distributions are made, it may be easier for the general partner to receive incentive distributions. However, any distribution of capital surplus before the unrecovered capital is reduced to zero cannot be applied to the payment of the minimum quarterly distribution.

Once we distribute capital surplus on a unit in an amount equal to the initial unit price, we will reduce the minimum quarterly distribution and the target distribution levels to zero. We will then make all future distributions from operating surplus, with 50% being paid to the holders of units, 48% to the holders of the incentive distribution rights and 2% to the general partner.

**Table of Contents**

**Index to Financial Statements**

**Adjustment to the Minimum Quarterly Distribution and Target Distribution Levels**

In addition to adjusting the minimum quarterly distribution and target distribution levels to reflect a distribution of capital surplus, if we combine our units into fewer units or subdivide our units into a greater number of units, we will proportionately adjust:

the minimum quarterly distribution;

the target distribution levels; and

unrecovered capital.

For example, if a two-for-one split of the common units should occur, the minimum quarterly distribution, the target distribution levels and the unrecovered capital would each be reduced to 50% of its initial level. We will not make any adjustment by reason of the issuance of additional units for cash or property.

In addition, if legislation is enacted or if existing law is modified or interpreted in a manner that causes us to become taxable as a corporation or otherwise subject to taxation as an entity for federal, state or local income tax purposes, we will reduce the minimum quarterly distribution and the target distribution levels by multiplying the same by one minus the sum of the highest marginal federal corporate income tax rate that could apply and any increase in the effective overall state and local income tax rates.

**Distributions of Cash Upon Liquidation**

*General.* If we dissolve in accordance with our partnership agreement, we will sell or otherwise dispose of our assets in a process called liquidation. We will first apply the proceeds of liquidation to the payment of our creditors. We will distribute any remaining proceeds to the unitholders and the general partner, in accordance with their capital account balances, as adjusted to reflect any gain or loss upon the sale or other disposition of our assets in liquidation.

Any further net gain recognized upon liquidation will be allocated in a manner that takes into account the incentive distribution rights of the general partner.

*Manner of Adjustments for Gain.* The manner of the adjustment for gain is set forth in our partnership agreement in the following manner:

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First, to the general partner and the holders of units who have negative balances in their capital accounts to the extent of and in proportion to those negative balances;

Second, 98% to the common unitholders, pro rata, and 2% to the general partner, until the capital account for each common unit is equal to the sum of:

the unrecovered capital; and

the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs;

- 123 -

**Table of Contents**

**Index to Financial Statements**

Third, 98% to all unitholders, pro rata, and 2% to the general partner, until we allocate under this paragraph an amount per unit equal to:

the sum of the excess of the first target distribution per unit over the minimum quarterly distribution per unit for each quarter of our existence; less

the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed 98% to the unitholders, pro rata, and 2% to the general partner, for each quarter of our existence;

Fourth, 85% to all unitholders, pro rata, 13% to the holders of the incentive distribution rights, pro rata, and 2% to the general partner, until we allocate under this paragraph an amount per unit equal to:

the sum of the excess of the second target distribution per unit over the first target distribution per unit for each quarter of our existence; less

the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the first target distribution per unit that we distributed 85% to the unitholders, pro rata, 13% to the holders of the incentive distribution rights, pro rata, and 2% to the general partner for each quarter of our existence;

Fifth, 75% to all unitholders, pro rata, 23% to the holders of the incentive distribution rights, pro rata, and 2% to the general partner, until we allocate under this paragraph an amount per unit equal to:

the sum of the excess of the third target distribution per unit over the second target distribution per unit for each quarter of our existence; less

the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the second target distribution per unit that we distributed 75% to the unitholders, pro rata, 23% to the holders of the incentive distribution rights, pro rata, and 2% to the general partner for each quarter of our existence; and

Sixth, thereafter, 50% to all unitholders, pro rata, 48% to the holders of the incentive distribution rights, pro rata, and 2% to the general partner.

*Manner of Adjustments for Losses.* Upon our liquidation, we will generally allocate any loss to the general partner and the unitholders in the following manner:

First, 98% to the holders of common units in proportion to the positive balances in their capital accounts and 2% to the general partner, until the capital accounts of the common unitholders have been reduced to zero; and

Second, thereafter, 100% to the general partner.



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*Adjustments to Capital Accounts upon the Issuance of Additional Units.* We will make adjustments to capital accounts upon the issuance of additional units. In doing so, we will allocate any unrealized and, for tax purposes, unrecognized gain or loss resulting from the adjustments to the unitholders and the general partner in the same manner as we allocate gain or loss upon liquidation. In the event that we make positive adjustments to

- 124 -

**Table of Contents**

**Index to Financial Statements**

the capital accounts upon the issuance of additional units, we will allocate any later negative adjustments to the capital accounts resulting from the issuance of additional units or upon our liquidation in a manner which results, to the extent possible, in the general partner's capital account balances equaling the amount which they would have been if no earlier positive adjustments to the capital accounts had been made.

**Table of Contents**

**Index to Financial Statements**

**DESCRIPTION OF THE DEBT SECURITIES**

Energy Transfer Partners, L.P. may issue senior debt securities on a senior unsecured basis under an indenture among Energy Transfer Partners, L.P., as issuer, the Subsidiary Guarantors, if any, and a trustee that we will name in the related prospectus supplement. We refer to this indenture as the Energy Transfer senior indenture. Energy Transfer Partners, L.P. may also issue subordinated debt securities under an indenture to be entered into among Energy Transfer Partners, L.P., the Subsidiary Guarantors, if any, and the trustee. We refer to this indenture as the Energy Transfer subordinated indenture.

Heritage Operating, L.P. may issue senior debt securities on a senior unsecured basis under an indenture among Heritage Operating, L.P., as issuer, Energy Transfer Partners, L.P., as Guarantor, the Subsidiary Guarantors, if any, and a trustee that we will name in the related prospectus supplement. We refer to this indenture as the Heritage Operating senior indenture. Heritage Operating, L.P. may also issue subordinated debt securities under an indenture to be entered into among Heritage Operating, L.P., the Guarantor, the Subsidiary Guarantors, if any, and the trustee. We refer to this indenture as the Heritage Operating subordinated indenture.

We refer to the Energy Transfer senior indenture, the Heritage Operating senior indenture, the Energy Transfer subordinated indenture and the Heritage Operating subordinated indenture collectively as the indentures. The debt securities will be governed by the provisions of the related indenture and those made part of the indenture by reference to the Trust Indenture Act.

We have summarized material provisions of the indentures, the debt securities and the guarantees below. This summary is not complete. We have filed the form of senior indentures and the form of subordinated indentures with the SEC as exhibits to the registration statement, and you should read the indentures for provisions that may be important to you.

References in this Description of the Debt Securities to we, us and our mean Energy Transfer Partners, L.P. and Heritage Operating, L.P. References in this prospectus to an indenture refer to the particular indenture under which we issue a series of debt securities.

**Provisions Applicable to Each Indenture**

*General.* Any series of debt securities:

will be general obligations of the issuer;

will be general obligations of the Guarantor if they are guaranteed by the Guarantor;

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will be general obligations of the Subsidiary Guarantors if they are guaranteed by the Subsidiary Guarantors; and

may be subordinated to the Senior Indebtedness of Energy Transfer Partners, L.P., Heritage Operating, L.P. and the Subsidiary Guarantors.

The indentures do not limit the amount of debt securities that may be issued under any indenture, and do not limit the amount of other unsecured debt or securities that we may issue. We may issue debt securities under the indentures from time to time in one or more series, each in an amount authorized prior to issuance.

- 126 -

**Table of Contents**

**Index to Financial Statements**

No indenture contains any covenants or other provisions designed to protect holders of the debt securities in the event we participate in a highly leveraged transaction or upon a change of control. The indentures also do not contain provisions that give holders the right to require us to repurchase their securities in the event of a decline in our credit ratings for any reason, including as a result of a takeover, recapitalization or similar restructuring or otherwise.

*Terms.* We will prepare a prospectus supplement and either a supplemental indenture, or authorizing resolutions of the board of directors of our general partner's general partner, accompanied by an officers' certificate, relating to any series of debt securities that we offer, which will include specific terms relating to some or all of the following:

whether the debt securities will be senior or subordinated debt securities;

the form and title of the debt securities of that series;

the total principal amount of the debt securities of that series;

whether the debt securities will be issued in individual certificates to each holder or in the form of temporary or permanent global securities held by a depository on behalf of holders;

the date or dates on which the principal of and any premium on the debt securities of that series will be payable;

any interest rate which the debt securities of that series will bear, the date from which interest will accrue, interest payment dates and record dates for interest payments;

any right to extend or defer the interest payment periods and the duration of the extension;

whether and under what circumstances any additional amounts with respect to the debt securities will be payable;

whether debt securities are entitled to the benefits of any guarantee of any Subsidiary Guarantor;

the place or places where payments on the debt securities of that series will be payable;

any provisions for optional redemption or early repayment;

any provisions that would require the redemption, purchase or repayment of debt securities;

the denominations in which the debt securities will be issued;

whether payments on the debt securities will be payable in foreign currency or currency units or another form and whether payments will be payable by reference to any index or formula;

- 127 -

**Table of Contents**

**Index to Financial Statements**

the portion of the principal amount of debt securities that will be payable if the maturity is accelerated, if other than the entire principal amount;

any additional means of defeasance of the debt securities, any additional conditions or limitations to defeasance of the debt securities or any changes to those conditions or limitations;

any changes or additions to the events of default or covenants described in this prospectus;

any restrictions or other provisions relating to the transfer or exchange of debt securities;

any terms for the conversion or exchange of the debt securities for our other securities or securities of any other entity;

any changes to the subordination provisions for the subordinated debt securities; and

any other terms of the debt securities of that series.

This description of debt securities will be deemed modified, amended or supplemented by any description of any series of debt securities set forth in a prospectus supplement related to that series.

We may sell the debt securities at a discount, which may be substantial, below their stated principal amount. These debt securities may bear no interest or interest at a rate that at the time of issuance is below market rates. If we sell these debt securities, we will describe in the prospectus supplement any material United States federal income tax consequences and other special considerations.

If we sell any of the debt securities for any foreign currency or currency unit or if payments on the debt securities are payable in any foreign currency or currency unit, we will describe in the prospectus supplement the restrictions, elections, tax consequences, specific terms and other information relating to those debt securities and the foreign currency or currency unit.

*Guarantee of Heritage Propane Partners, L.P.* Energy Transfer Partners, L.P. will fully, irrevocably and unconditionally guarantee on an unsecured basis all series of debt securities of Heritage Operating, L.P., and will execute a notation of guarantee as further evidence of its guarantee. As used in this prospectus, the term "Guarantor" means Energy Transfer Partners, L.P. in its role as guarantor of the debt securities of Heritage Operating, L.P. The applicable prospectus supplement will describe the terms of any guarantee by Energy Transfer Partners, L.P.

If a series of senior debt securities of Heritage Operating, L.P. is so guaranteed, Energy Transfer Partners, L.P.'s guarantee of the senior debt securities will be Energy Transfer Partners, L.P.'s unsecured and unsubordinated general obligation, and will rank on a parity with all of Energy Transfer Partners, L.P.'s other unsecured and unsubordinated indebtedness. If a series of subordinated debt securities of Heritage Operating, L.P. is so guaranteed, Energy Transfer Partners, L.P.'s guarantee of the subordinated debt securities will be Energy Transfer Partners, L.P.'s unsecured general obligation and will be subordinated to all of Energy Transfer Partners, L.P.'s other unsecured and unsubordinated indebtedness.





**Table of Contents**

**Index to Financial Statements**

*The Subsidiary Guarantees.* The Subsidiary Guarantors may fully, irrevocably and unconditionally guarantee on an unsecured basis all series of debt securities of Energy Transfer Partners, L.P. or Heritage Operating, L.P., and will execute a notation of guarantee as further evidence of their guarantee. The term Subsidiary Guarantors means Heritage Service Corp., Heritage-Bi State, L.L.C. and Heritage Energy Resources, L.L.C. and also includes Heritage Operating, L.P. when discussing subsidiary guarantees of the debt securities of Energy Transfer Partners, L.P. The applicable prospectus supplement will describe the terms of any guarantee by the Subsidiary Guarantors.

If a series of senior debt securities of Energy Transfer Partners, L.P. or Heritage Operating, L.P. is so guaranteed, the Subsidiary Guarantors guarantee of the senior debt securities will be the Subsidiary Guarantors unsecured and unsubordinated general obligation, and will rank on a parity with all of the Subsidiary Guarantors other unsecured and unsubordinated indebtedness. If a series of subordinated debt securities of Energy Transfer Partners, L.P. or Heritage Operating, L.P. is so guaranteed, the Subsidiary Guarantors guarantee of the subordinated debt securities will be the Subsidiary Guarantors unsecured general obligation and will be subordinated to all of the Subsidiary Guarantors other unsecured and unsubordinated indebtedness.

The obligations of each Subsidiary Guarantor under its guarantee of the debt securities will be limited to the maximum amount that will not result in the obligations of the Subsidiary Guarantor under the guarantee constituting a fraudulent conveyance or fraudulent transfer under federal or state law, after giving effect to:

all other contingent and fixed liabilities of the Subsidiary Guarantor; and

any collections from or payments made by or on behalf of any other Subsidiary Guarantors in respect of the obligations of the Subsidiary Guarantor under its guarantee.

The guarantee of any Subsidiary Guarantor may be released under certain circumstances. If we exercise our legal or covenant defeasance option with respect to debt securities of a particular series as described below in Defeasance, then any Subsidiary Guarantor will be released with respect to that series. Further, if no default has occurred and is continuing under the indentures, and to the extent not otherwise prohibited by the indentures, a Subsidiary Guarantor will be unconditionally released and discharged from the guarantee:

automatically upon any sale, exchange or transfer, whether by way of merger or otherwise, to any person that is not our affiliate, of all of our direct or indirect limited partnership or other equity interests in the Subsidiary Guarantor;

automatically upon the merger of the Subsidiary Guarantor into us or any other Subsidiary Guarantor or the liquidation and dissolution of the Subsidiary Guarantor; or

following delivery of a written notice by us to the trustee, upon the release of all guarantees by the Subsidiary Guarantor of any debt of ours for borrowed money for a purchase money obligation or for a guarantee of either, except for any series of debt securities.

*Consolidation, Merger and Sale of Assets.* The indentures generally permit a consolidation or merger involving Energy Transfer Partners, L.P., Heritage Operating, L.P. or the Subsidiary Guarantors. They also permit Energy Transfer Partners, L.P., Heritage Operating, L.P. or the Subsidiary Guarantors, as applicable, to



**Table of Contents**

**Index to Financial Statements**

lease, transfer or dispose of all or substantially all of its assets. Each of Energy Transfer Partners, L.P., Heritage Operating, L.P. and the Subsidiary Guarantors has agreed, however, that it will not consolidate with or merge into any entity (other than Energy Transfer Partners, L.P., Heritage Operating, L.P. or a Subsidiary Guarantor, as applicable) or lease, transfer or dispose of all or substantially all of its assets to any entity (other than Energy Transfer Partners, L.P., Heritage Operating, L.P. or a Subsidiary Guarantor, as applicable) unless:

it is the continuing entity; or

if it is not the continuing entity, the resulting entity or transferee is organized and existing under the laws of any United States jurisdiction and assumes the performance of its covenants and obligations under the indentures; and

in either case, immediately after giving effect to the transaction, no default or event of default would occur and be continuing or would result from the transaction.

Upon any such consolidation, merger or asset lease, transfer or disposition involving Energy Transfer Partners, L.P., Heritage Operating, L.P. or the Subsidiary Guarantors, the resulting entity or transferee will be substituted for Energy Transfer Partners, L.P., Heritage Operating, L.P. or the Subsidiary Guarantors, as applicable, under the applicable indenture and debt securities. In the case of an asset transfer or disposition other than a lease, Energy Transfer Partners, L.P. or the Subsidiary Guarantors, as applicable, will be released from the applicable indenture.

*Events of Default.* Unless we inform you otherwise in the applicable prospectus supplement, the following are events of default with respect to a series of debt securities:

failure to pay interest on that series of debt securities for 30 days when due;

default in the payment of principal or premium, if any, on any debt securities of that series when due at its stated maturity, upon redemption, upon required repurchase or otherwise;

default in the payment of any sinking fund payment on any debt securities of that series when due;

failure by us or, if the series of debt securities is guaranteed by the Guarantor or any Subsidiary Guarantors, by such Guarantor or Subsidiary Guarantor, to comply for 60 days after notice with the other agreements contained in the indentures, any supplement to the indentures or any board resolution authorizing the issuance of that series;

failure to comply with any covenant or agreement in that series of debt securities or the applicable indenture for 60 days after written notice by the trustee or by the holders of at least 25% in principal amount of the outstanding debt securities issued under that indenture that are affected by that failure;

certain events of bankruptcy, insolvency or reorganization of us or, if the series of debt securities is guaranteed by the Guarantor or any Subsidiary Guarantor, of the Guarantor and/or any such Subsidiary Guarantor;



**Table of Contents**

**Index to Financial Statements**

if the series of debt securities is guaranteed by the Guarantor and/or any Subsidiary Guarantor:

any of the guarantees ceases to be in full force and effect, except as otherwise provided in the indentures;

any of the guarantees is declared null and void in a judicial proceeding; or

the Guarantor or any Subsidiary Guarantor denies or disaffirms its obligations under the indentures or its guarantee; and

any other event of default provided for in that series of debt securities.

A default under one series of debt securities will not necessarily be a default under another series. The trustee may withhold notice to the holders of the debt securities of any default or event of default (except in any payment on the debt securities) if the trustee considers it in the interest of the holders of the debt securities to do so.

If an event of default for any series of debt securities occurs and is continuing, the trustee or the holders of at least 25% in principal amount of the outstanding debt securities of the series affected by the default (or, in some cases, 25% in principal amount of all debt securities issued under the applicable indenture that are affected, voting as one class) may declare the principal of and all accrued and unpaid interest on those debt securities to be due and payable. If an event of default relating to certain events of bankruptcy, insolvency or reorganization occurs, the principal of and interest on all the debt securities issued under the applicable indenture will become immediately due and payable without any action on the part of the trustee or any holder. The holders of a majority in principal amount of the outstanding debt securities of the series affected by the default (or, in some cases, of all debt securities issued under the applicable indenture that are affected, voting as one class) may in some cases rescind this accelerated payment requirement.

A holder of a debt security of any series issued under each indenture may pursue any remedy under that indenture only if:

the holder gives the trustee written notice of a continuing event of default for that series;

the holders of at least 25% in principal amount of the outstanding debt securities of that series make a written request to the trustee to pursue the remedy;

the holders offer to the trustee indemnity satisfactory to the trustee;

the trustee fails to act for a period of 60 days after receipt of the request and offer of indemnity; and

during that 60-day period, the holders of a majority in principal amount of the debt securities of that series do not give the trustee a direction inconsistent with the request.

*This provision does not, however, affect the right of a holder of a debt security to sue for enforcement of any overdue payment.*

**Table of Contents**

**Index to Financial Statements**

In most cases, holders of a majority in principal amount of the outstanding debt securities of a series (or of all debt securities issued under the applicable indenture that are affected, voting as one class) may direct the time, method and place of:

conducting any proceeding for any remedy available to the trustee; and

exercising any trust or power conferred upon the trustee relating to or arising as a result of an event of default.

Under each of the indentures we are required to file each year with the trustee a written statement as to their compliance with the covenants contained in the applicable indenture.

*Modification and Waiver.* Each indenture may be amended or supplemented if the holders of a majority in principal amount of the outstanding debt securities of all series issued under that indenture that are affected by the amendment or supplement (acting as one class) consent to it. Without the consent of the holder of each debt security affected, however, no modification may:

reduce the amount of debt securities whose holders must consent to an amendment, a supplement or a waiver;

reduce the rate of or change the time for payment of interest on the debt security;

reduce the principal of the debt security or change its stated maturity;

reduce any premium payable on the redemption of the debt security or change the time at which the debt security may or must be redeemed;

change any obligation to pay additional amounts on the debt security;

make payments on the debt security payable in currency other than as originally stated in the debt security;

impair the holder's right to institute suit for the enforcement of any payment on or with respect to the debt security;

make any change in the percentage of principal amount of debt securities necessary to waive compliance with certain provisions of the indenture or to make any change in the provision related to modification;

modify the provisions relating to the subordination of any subordinated debt security in a manner adverse to the holder of that security;

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waive a continuing default or event of default regarding any payment on the debt securities; or

release the Guarantor, or any Subsidiary Guarantor, or modify the guarantee of the Guarantor or any Subsidiary Guarantor in any manner adverse to the holders.

- 132 -



**Table of Contents**

**Index to Financial Statements**

Each indenture may be amended or supplemented or any provision of that indenture may be waived without the consent of any holders of debt securities issued under that indenture:

to cure any ambiguity, omission, defect or inconsistency;

to provide for the assumption of our obligations under the indentures by a successor upon any merger, consolidation or asset transfer permitted under the indenture;

to provide for uncertificated debt securities in addition to or in place of certificated debt securities or to provide for bearer debt securities;

to provide any security for, any guarantees of or any additional obligors on any series of debt securities or, with respect to the senior indentures, the related guarantees;

to comply with any requirement to effect or maintain the qualification of that indenture under the Trust Indenture Act of 1939;

to add covenants that would benefit the holders of any debt securities or to surrender any rights we have under the indentures;

to add events of default with respect to any debt securities; and

to make any change that does not adversely affect any outstanding debt securities of any series issued under that indenture in any material respect.

The holders of a majority in principal amount of the outstanding debt securities of any series (or, in some cases, of all debt securities issued under the applicable indenture that are affected, voting as one class) may waive any existing or past default or event of default with respect to those debt securities. Those holders may not, however, waive any default or event of default in any payment on any debt security or compliance with a provision that cannot be amended or supplemented without the consent of each holder affected.

*Defeasance.* When we use the term defeasance, we mean discharge from some or all of our obligations under the indentures. If any combination of funds or government securities are deposited with the trustee under an indenture sufficient to make payments on the debt securities of a series issued under that indenture on the dates those payments are due and payable, then, at our option, either of the following will occur:

we will be discharged from our or their obligations with respect to the debt securities of that series and, if applicable, the related guarantees ( legal defeasance ); or

we will no longer have any obligation to comply with the restrictive covenants, the merger covenant and other specified covenants under the applicable indenture, and the related events of default will no longer apply ( covenant defeasance ).

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If a series of debt securities is defeased, the holders of the debt securities of the series affected will not be entitled to the benefits of the applicable indenture, except for obligations to register the transfer or exchange of debt securities, replace stolen, lost or mutilated debt securities or maintain paying agencies and hold moneys for

- 133 -

**Table of Contents**

**Index to Financial Statements**

payment in trust. In the case of covenant defeasance, our obligation to pay principal, premium and interest on the debt securities and, if applicable, guarantees of the payments will also survive.

Unless we inform you otherwise in the prospectus supplement, we will be required to deliver to the trustee an opinion of counsel that the deposit and related defeasance would not cause the holders of the debt securities to recognize income, gain or loss for U.S. federal income tax purposes. If we elect legal defeasance, that opinion of counsel must be based upon a ruling from the U.S. Internal Revenue Service or a change in law to that effect.

*No Personal Liability of General Partner.* U.S. Propane, L.P., our general partner, and its directors, officers, employees, incorporators and partners, in such capacity, will not be liable for the obligations of Energy Transfer Partners, L.P., Heritage Operating, L.P. or any Subsidiary Guarantor under the debt securities, the indentures or the guarantees or for any claim based on, in respect of, or by reason of, such obligations or their creation. By accepting a debt security, each holder of that debt security will have agreed to this provision and waived and released any such liability on the part of U.S. Propane, L.P. and its directors, officers, employees, incorporators and partners. This waiver and release are part of the consideration for our issuance of the debt securities. It is the view of the SEC that a waiver of liabilities under the federal securities laws is against public policy and unenforceable.

*Governing Law.* New York law will govern the indentures and the debt securities.

*Trustee.* We may appoint a separate trustee for any series of debt securities. We use the term trustee to refer to the trustee appointed with respect to any such series of debt securities. We may maintain banking and other commercial relationships with the trustee and its affiliates in the ordinary course of business, and the trustee may own debt securities.

*Form, Exchange, Registration and Transfer.* The debt securities will be issued in registered form, without interest coupons. There will be no service charge for any registration of transfer or exchange of the debt securities. However, payment of any transfer tax or similar governmental charge payable for that registration may be required.

Debt securities of any series will be exchangeable for other debt securities of the same series, the same total principal amount and the same terms but in different authorized denominations in accordance with the applicable indenture. Holders may present debt securities for registration of transfer at the office of the security registrar or any transfer agent we designate. The security registrar or transfer agent will effect the transfer or exchange if its requirements and the requirements of the applicable indenture are met.

The trustee will be appointed as security registrar for the debt securities. If a prospectus supplement refers to any transfer agents we initially designate, we may at any time rescind that designation or approve a change in the location through which any transfer agent acts. We are required to maintain an office or agency for transfers and exchanges in each place of payment. We may at any time designate additional transfer agents for any series of debt securities.

In the case of any redemption, we will not be required to register the transfer or exchange of:

any debt security during a period beginning 15 business days prior to the mailing of the relevant notice of redemption and ending on the close of business on the day of mailing of such notice; or

- 134 -

**Table of Contents**

**Index to Financial Statements**

any debt security that has been called for redemption in whole or in part, except the unredeemed portion of any debt security being redeemed in part.

*Payment and Paying Agents.* Unless we inform you otherwise in a prospectus supplement, payments on the debt securities will be made in U.S. dollars at the office of the trustee and any paying agent. At our option, however, payments may be made by wire transfer for global debt securities or by check mailed to the address of the person entitled to the payment as it appears in the security register. Unless we inform you otherwise in a prospectus supplement, interest payments may be made to the person in whose name the debt security is registered at the close of business on the record date for the interest payment.

Unless we inform you otherwise in a prospectus supplement, the trustee under the applicable indenture will be designated as the paying agent for payments on debt securities issued under that indenture. We may at any time designate additional paying agents or rescind the designation of any paying agent or approve a change in the office through which any paying agent acts.

If the principal of or any premium or interest on debt securities of a series is payable on a day that is not a business day, the payment will be made on the following business day. For these purposes, unless we inform you otherwise in a prospectus supplement, a business day is any day that is not a Saturday, a Sunday or a day on which banking institutions in New York, New York or a place of payment on the debt securities of that series is authorized or obligated by law, regulation or executive order to remain closed.

Subject to the requirements of any applicable abandoned property laws, the trustee and paying agent will pay to us upon written request any money held by them for payments on the debt securities that remains unclaimed for two years after the date upon which that payment has become due. After payment to us, holders entitled to the money must look to us for payment. In that case, all liability of the trustee or paying agent with respect to that money will cease.

*Book-Entry Debt Securities.* The debt securities of a series may be issued in the form of one or more global debt securities that would be deposited with a depository or its nominee identified in the prospectus supplement. Global debt securities may be issued in either temporary or permanent form. We will describe in the prospectus supplement the terms of any depository arrangement and the rights and limitations of owners of beneficial interests in any global debt security.

**Provisions Applicable Solely to the Energy Transfer and Heritage Operating Subordinated Indentures**

*Subordination.* Debt securities of a series may be subordinated to our Senior Indebtedness, which we define generally to include any obligation created or assumed by us (or, if the series is guaranteed, the Guarantor and any Subsidiary Guarantors) for the repayment of borrowed money, any purchase money obligation created or assumed by us, and any guarantee therefor, whether outstanding or hereafter issued, unless, by the terms of the instrument creating or evidencing such obligation, it is provided that such obligation is subordinate or not superior in right of payment to the debt securities (or, if the series is guaranteed, the guarantee of the Guarantor or any Subsidiary Guarantor), or to other obligations which are pari passu with or subordinated to the debt securities (or, if the series is guaranteed, the guarantee of the Guarantor or any Subsidiary Guarantor). Subordinated debt securities will be subordinated in right of payment, to the extent and in the manner set forth in the subordinated indentures and the prospectus supplement relating to such series, to



**Table of Contents**

**Index to Financial Statements**

the prior payment of all of our indebtedness and that of the Guarantor or any Subsidiary Guarantor that is designated as Senior Indebtedness with respect to the series.

The holders of Senior Indebtedness of ours or, if applicable, the Guarantor or a Subsidiary Guarantor, will receive payment in full of the Senior Indebtedness before holders of subordinated debt securities will receive any payment of principal, premium or interest with respect to the subordinated debt securities upon any payment or distribution of our assets or, if applicable to any series of outstanding debt securities, the Subsidiary Guarantors' assets, to creditors:

upon a liquidation or dissolution of us or, if applicable to any series of outstanding debt securities, the Subsidiary Guarantors; or

in a bankruptcy, receivership or similar proceeding relating to us or, if applicable to any series of outstanding debt securities, to the Subsidiary Guarantors.

Until the Senior Indebtedness is paid in full, any distribution to which holders of subordinated debt securities would otherwise be entitled will be made to the holders of Senior Indebtedness, except that the holders of subordinated debt securities may receive units representing limited partner interests and any debt securities that are subordinated to Senior Indebtedness to at least the same extent as the subordinated debt securities.

If we do not pay any principal, premium or interest with respect to Senior Indebtedness within any applicable grace period (including at maturity), or any other default on Senior Indebtedness occurs and the maturity of the Senior Indebtedness is accelerated in accordance with its terms, we may not:

make any payments of principal, premium, if any, or interest with respect to subordinated debt securities;

make any deposit for the purpose of defeasance of the subordinated debt securities; or

repurchase, redeem or otherwise retire any subordinated debt securities, except that in the case of subordinated debt securities that provide for a mandatory sinking fund, we may deliver subordinated debt securities to the trustee in satisfaction of our sinking fund obligation,

*unless, in either case,*

the default has been cured or waived and any declaration of acceleration has been rescinded;

the Senior Indebtedness has been paid in full in cash; or

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we and the trustee receive written notice approving the payment from the representatives of each issue of Designated Senior Indebtedness.

Generally, Designated Senior Indebtedness will include:

any specified issue of Senior Indebtedness of at least \$100 million; and

- 136 -



**Table of Contents**

**Index to Financial Statements**

any other Senior Indebtedness that we may designate in respect of any series of subordinated debt securities.

During the continuance of any default, other than a default described in the immediately preceding paragraph, that may cause the maturity of any Designated Senior Indebtedness to be accelerated immediately without further notice, other than any notice required to effect such acceleration, or the expiration of any applicable grace periods, we may not pay the subordinated debt securities for a period called the Payment Blockage Period. A Payment Blockage Period will commence on the receipt by us and the trustee of written notice of the default, called a Blockage Notice, from the representative of any Designated Senior Indebtedness specifying an election to effect a Payment Blockage Period and will end 179 days thereafter.

The Payment Blockage Period may be terminated before its expiration:

by written notice from the person or persons who gave the Blockage Notice;

by repayment in full in cash of the Designated Senior Indebtedness with respect to which the Blockage Notice was given; or

if the default giving rise to the Payment Blockage Period is no longer continuing.

Unless the holders of the Designated Senior Indebtedness have accelerated the maturity of the Designated Senior Indebtedness, we may resume payments on the subordinated debt securities after the expiration of the Payment Blockage Period.

Generally, not more than one Blockage Notice may be given in any period of 360 consecutive days. The total number of days during which any one or more Payment Blockage Periods are in effect, however, may not exceed an aggregate of 179 days during any period of 360 consecutive days.

After all Senior Indebtedness is paid in full and until the subordinated debt securities are paid in full, holders of the subordinated debt securities shall be subrogated to the rights of holders of Senior Indebtedness to receive distributions applicable to Senior Indebtedness.

As a result of the subordination provisions described above, in the event of insolvency, the holders of Senior Indebtedness, as well as certain of our general creditors, may recover more, ratably, than the holders of the subordinated debt securities.

**Table of Contents****Index to Financial Statements****SELLING UNITHOLDERS**

In addition to covering our offering of securities, this prospectus covers the offering for resale of up to 1,988,846 common units by selling unitholders. The following table sets forth information relating to the selling unitholders' beneficial ownership of our common units as of the date of this prospectus.

| Name of Selling Unitholder | Nature of Any Position, Office or Other Relationship | Number of    | Number of               | Number of                 |
|----------------------------|--|--------------|-------------------------|---------------------------|
|                            |  | Common Units | Common Units            | Common Units              |
|                            |  | Owned(1)(2)  | Available for Resale(1) | Available After Resale(3) |
| U.S. Propane, L.P.(4)      | General Partner                                      | 180,028      | 180,028                 |                           |
| James E. Bertelsmeyer      | Chairman of the Board of Directors                   | 1,103,622    | 1,027,946               | 75,676                    |
| H. Michael Krimbill        | Director, President and Chief Executive Officer      | 335,892      | 292,059                 | 43,833                    |
| R.C. Mills                 | Executive Vice President and Chief Operating Officer | 341,342      | 305,509                 | 35,833                    |
| Bill W. Byrne              | Director   | 78,157       | 64,157                  | 14,000                    |
| J. Charles Sawyer          | Director   | 68,657       | 64,157                  | 4,500                     |
| Mark A. Darr               | Vice President Southern Operations                   | 27,880       | 18,330                  | 9,550                     |
| Thomas H. Rose             | Vice President Northern Operations                   | 37,455       | 18,330                  | 19,125                    |
| Curtis L. Weishahn         | Vice President Western Operations                    | 29,455       | 18,330                  | 11,125                    |

(1) As of January 10, 2004.

(2) This amount includes the amount of unregistered common units available for resale pursuant to this registration statement.

(3) Assumes all of the common units available for resale by each of the selling unitholders have been sold.

(4) AGL Propane Services, Inc., United Cities Propane Gas, Inc., TECO Propane Ventures, LLC and Piedmont Propane Company respectively own a 22.538%, 18.968%, 37.976% and 20.688% limited partner interest in U.S. Propane, L.P. U.S. Propane, L.L.C. is the general partner of U.S. Propane, L.P., with a 0.01% general partner interest. AGL Energy Corporation, United Cities Propane Gas, Inc., TECO Propane Ventures, LLC and Piedmont Propane Company respectively own 22.36%, 18.97%, 37.98% and 20.69% of the member interests of U.S. Propane, L.L.C.

The applicable prospectus supplement will set forth, with respect to the selling unitholders:

the name of the selling unitholders in that offering;



**Table of Contents**

**Index to Financial Statements**

the nature of the position, office or other material relationship which the selling unitholders will have had within the prior three years with us or any of our affiliates;

the number of common units owned by the selling unitholders prior to the offering;

the number of common units to be offered for the selling unitholders' account; and

the number and (if one percent or more) the percentage of common units to be owned by the selling unitholders after the completion of the offering.

All expenses incurred with the registration of the common units owned by the selling unitholders, excluding any separate legal fees and expenses of the selling unitholders, will be borne by us.

Table of Contents

Index to Financial Statements

**MATERIAL TAX CONSIDERATIONS**

This section is a summary of the material tax consequences that may be relevant to prospective unitholders who are individual citizens or residents of the United States and, unless otherwise noted in the following discussion, is the opinion of Vinson & Elkins L.L.P., counsel to our general partner and us, insofar as it relates to matters of United States federal income tax law and legal conclusions with respect to those matters. This section is based upon current provisions of the Internal Revenue Code, existing and proposed regulations and current administrative rulings and court decisions, all of which are subject to change. Later changes in these authorities may cause the tax consequences to vary substantially from the consequences described below. Unless the context otherwise requires, references in this section to us or we are references to Energy Transfer Partners, L.P. and Heritage Operating, L.P.

No attempt has been made in this section to comment on all federal income tax matters affecting us or the unitholders. Moreover, the discussion focuses on unitholders who are individual citizens or residents of the United States and has only limited application to corporations, estates, trusts, nonresident aliens or other unitholders subject to specialized tax treatment, such as tax-exempt institutions, foreign persons, individual retirement accounts (IRAs), real estate investment trusts (REITs) or mutual funds. Accordingly, we recommend that you consult, and depend on, your own tax advisor in analyzing the federal, state, local and foreign tax consequences particular to you of an investment in, or the disposition of, our securities.

All statements as to matters of law and legal conclusions, but not as to factual matters, contained in this section, unless otherwise noted, are the opinion of counsel, and some are based on the accuracy of the representations we make.

No ruling has been or will be requested from the IRS regarding any matter affecting us or prospective unitholders. An opinion of counsel represents only that counsel's best legal judgment and does not bind the IRS or the courts. Accordingly, the opinions and statements made here may not be sustained by a court if contested by the IRS. Any contest of this sort with the IRS may materially and adversely impact the market for the common units and the prices at which common units trade. In addition, the costs of any contest with the IRS will be borne directly or indirectly by the unitholders and the general partner. Furthermore, the tax treatment of us or of an investment in us, may be significantly modified by future legislative or administrative changes or court decisions. Any modifications may or may not be retroactively applied.

For the reasons described below, counsel has not rendered an opinion with respect to the following specific federal income tax issues:

(a) the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units (please read Tax Consequences of Unit Ownership Treatment of Short Sales );

(b) whether our monthly convention for allocating taxable income and losses is permitted by existing Treasury regulations (please read Disposition of Common Units Allocations Between Transferors and Transferees ); and

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(c) whether our method for depreciating Section 743 adjustments is sustainable (please read Tax Consequences of Unit Ownership Section 754 Election ).

- 140 -

**Table of Contents**

**Index to Financial Statements**

**Partnership Status**

A partnership is not a taxable entity and incurs no federal income tax liability. Instead, each partner of a partnership is required to take into account his allocable share of items of income, gain, loss and deduction of the partnership in computing his federal income tax liability, regardless of whether cash distributions are made to him by the partnership. Distributions of cash by a partnership to a partner generally are not taxable unless the amount of cash distributed is in excess of the partner's adjusted basis in his partnership interest.

No ruling has been or will be sought from the IRS and the IRS has made no determination as to the status of Energy Transfer Partners, L.P. as a partnership for federal income tax purposes or whether our operations generate qualifying income under Section 7704 of the Code, or any other matter affecting our prospective unitholders.

Instead, we have relied on the opinion of Vinson & Elkins L.L.P. that, based upon the Internal Revenue Code, its regulations, published revenue rulings and court decisions and the representations described below, Energy Transfer Partners, L.P. has been, is, and will continue to be, classified as a partnership for federal income tax purposes.

In rendering its opinion, Vinson & Elkins L.L.P. has relied on factual representations made by us and our general partner. The representations made by us and our general partner upon which counsel has relied are:

- (a) Neither we nor Heritage Operating, L.P. has elected or will elect to be treated as a corporation;
- (b) Energy Transfer Partners, L.P. and Heritage Operating, L.P. have been and will be operated in accordance with applicable partnership statutes, the applicable partnership agreement and in the manner described in this prospectus; and
- (c) For each taxable year, more than 90% of our gross income has been and will be income that Vinson & Elkins L.L.P. has opined or will opine is qualifying income within the meaning of Section 7704(d) of the Internal Revenue Code.

Section 7704 of the Internal Revenue Code provides that publicly-traded partnerships will, as a general rule, be taxed as corporations. However, an exception, referred to as the Qualifying Income Exception, exists with respect to publicly-traded partnerships of which 90% or more of the gross income for every taxable year consists of qualifying income. Qualifying income includes income and gains derived from the processing, transportation and marketing of crude oil, natural gas and products thereof, including the retail and wholesale marketing of propane, certain hedging activities and the transportation of propane and natural gas liquids. Other types of qualifying income include interest other than from a financial business, dividends, gains from the sale of real property and gains from the sale or other disposition of assets held for the production of income that otherwise constitutes qualifying income. We estimate that less than seven percent of our current gross income is not qualifying income; however, this estimate could change from time to time. Based upon and subject to this estimate, the factual representations made by us and the general partner and a review of the applicable legal authorities, Vinson & Elkins L.L.P. is of the opinion that at least 90% of our current

gross income constitutes qualifying income.

If we fail to meet the Qualifying Income Exception, other than a failure which is determined by the IRS to be inadvertent and which is cured within a reasonable time after discovery, we will be treated as if we had

- 141 -



**Table of Contents**

**Index to Financial Statements**

transferred all of our assets, subject to liabilities, to a newly formed corporation, on the first day of the year in which we fail to meet the Qualifying Income Exception, in return for stock in that corporation, and then distributed that stock to the unitholders in liquidation of their interests in us. This contribution and liquidation should be tax-free to unitholders and us so long as we, at that time, do not have liabilities in excess of the tax basis of our assets. Thereafter, we would be treated as a corporation for federal income tax purposes.

If we were treated as an association taxable as a corporation in any taxable year, either as a result of a failure to meet the Qualifying Income Exception or otherwise, our items of income, gain, loss and deduction would be reflected only on our separate tax returns rather than being passed through to the unitholders, and our net income would be taxed to us at corporate rates. In addition, any distribution made to a unitholder would be treated as either taxable dividend income, to the extent of our current or accumulated earnings and profits, or, in the absence of earnings and profits, a nontaxable return of capital, to the extent of the unitholder's tax basis in his common units, or taxable capital gain, after the unitholder's tax basis in his common units is reduced to zero. Accordingly, taxation as a corporation would result in a material reduction in a unitholder's cash flow and after-tax return and thus would likely result in a substantial reduction of the value of the units.

The remainder of this section is based on Vinson & Elkins L.L.P.'s opinion that Energy Transfer Partners, L.P. and Heritage Operating, L.P. will be classified as partnerships for federal income tax purposes.

**Limited Partner Status**

Unitholders who have become limited partners of Energy Transfer Partners, L.P. will be treated as partners of Energy Transfer Partners, L.P. for federal income tax purposes. Also:

(a) assignees who have executed and delivered transfer applications, and are awaiting admission as limited partners, and

(b) unitholders whose common units are held in street name or by a nominee and who have the right to direct the nominee in the exercise of all substantive rights attendant to the ownership of their common units,

*will be treated as partners of Energy Transfer Partners, L.P. for federal income tax purposes. As there is no direct authority addressing assignees of common units who are entitled to execute and deliver transfer applications and become entitled to direct the exercise of attendant rights, but who fail to execute and deliver transfer applications, counsel's opinion does not extend to these persons. Furthermore, a purchaser or other transferee of common units who does not execute and deliver a transfer application may not receive some federal income tax information or reports furnished to record holders of common units unless the common units are held in a nominee or street name account and the nominee or broker has executed and delivered a transfer application for those common units.*

A beneficial owner of common units whose units have been transferred to a short seller to complete a short sale would appear to lose his status as a partner with respect to those units for federal income tax purposes. Please read Tax Consequences of Unit Ownership Treatment of Short Sales.

Income, gain, deductions or losses would not appear to be reportable by a unitholder who is not a partner for federal income tax purposes, and any cash distributions received by a unitholder who is not a partner for federal income tax purposes would therefore be fully taxable as ordinary income. These holders should consult their own tax advisors with respect to their status as partners in Energy Transfer Partners, L.P. for federal income tax purposes.

- 142 -

**Table of Contents**

**Index to Financial Statements**

**Tax Consequences of Unit Ownership**

*Flow-through of Taxable Income.* We will not pay any federal income tax. Instead, each unitholder will be required to report on his income tax return his allocable share of our income, gains, losses and deductions without regard to whether corresponding cash distributions are received by him. Consequently, we may allocate income to a unitholder even if he has not received a cash distribution. Each unitholder will be required to include in income his allocable share of our income, gains, losses and deductions for our taxable year ending with or within his taxable year.

*Treatment of Distributions.* Our distributions to a unitholder generally will not be taxable to the unitholder for federal income tax purposes to the extent of his tax basis in his common units immediately before the distribution. Our cash distributions in excess of a unitholder's tax basis generally will be considered to be gain from the sale or exchange of the common units, taxable in accordance with the rules described under *Disposition of Common Units* below. Any reduction in a unitholder's share of our liabilities for which no partner, including the general partner, bears the economic risk of loss, known as nonrecourse liabilities, will be treated as a distribution of cash to that unitholder. To the extent our distributions cause a unitholder's at risk amount to be less than zero at the end of any taxable year, he must recapture any losses deducted in previous years that are equal to the amount of that shortfall. Please read *Limitations on Deductibility of Losses*.

A decrease in a unitholder's percentage interest in us because of our issuance of additional common units will decrease his share of our nonrecourse liabilities, and thus will result in a corresponding deemed distribution of cash. A non-pro rata distribution of money or property may result in ordinary income to a unitholder, regardless of his tax basis in his common units, if that distribution reduces the unitholder's share of our unrealized receivables, including depreciation recapture, and/or substantially appreciated inventory items, both as defined in the Internal Revenue Code, and collectively, *Section 751 Assets*.

To that extent, he will be treated as having been distributed his proportionate share of the *Section 751 Assets* and having exchanged those assets with us in return for the non-pro rata portion of the actual distribution made to him. This latter deemed exchange generally will result in the unitholder's realization of ordinary income. That income will equal the excess of (1) the non-pro rata portion of that distribution over (2) the unitholder's tax basis for the share of *Section 751 Assets* deemed relinquished in the exchange.

*Basis of Common Units.* A unitholder's initial tax basis for his common units will be the amount he paid for the common units plus his share of our nonrecourse liabilities. That basis will be increased by his share of our income and by any increases in his share of our nonrecourse liabilities. That basis will be decreased, but not below zero, by distributions from us, by the unitholder's share of our losses, by any decreases in his share of our nonrecourse liabilities and by his share of our expenditures that are not deductible in computing taxable income and are not required to be capitalized. A limited partner will have no share of our debt which is recourse to the general partner, but will have a share, generally based on his share of profits, of our nonrecourse liabilities. Please read *Disposition of Common Units* *Recognition of Gain or Loss*.

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**Table of Contents**

**Index to Financial Statements**

*Limitations on Deductibility of Losses.* The deduction by a unitholder of his share of our losses will be limited to the tax basis in his units and, in the case of an individual unitholder or a corporate unitholder that is subject to the at risk rules (for example, if more than 50% of the value of the corporate unitholder's stock is owned directly or indirectly by five or fewer individuals or some tax-exempt organizations), to the amount for which the unitholder is considered to be at risk with respect to our activities, if that is less than his tax basis. A unitholder must recapture losses deducted in previous years to the extent that distributions cause his at risk amount to be less than zero at the end of any taxable year. Losses disallowed to a unitholder or recaptured as a result of these limitations will carry forward and will be allowable to the extent that his tax basis or at risk amount, whichever is the limiting factor, is subsequently increased. Upon the taxable disposition of a common unit, any gain recognized by a unitholder can be offset by losses that were previously suspended by the at risk limitation but may not be offset by losses suspended by the basis limitation. Any excess loss above that gain previously suspended by the at risk or basis limitations is no longer utilizable.

In general, a unitholder will be at risk to the extent of the tax basis of his common units, excluding any portion of that basis attributable to his share of our nonrecourse liabilities, reduced by any amount of money he borrows to acquire or hold his common units, if the lender of those borrowed funds owns an interest in us, is related to the unitholder or can look only to the units for repayment. A unitholder's at risk amount will increase or decrease as the tax basis of the unitholder's common units increases or decreases, other than tax basis increases or decreases attributable to increases or decreases in his share of our nonrecourse liabilities.

The passive loss limitations generally provide that individuals, estates, trusts and some closely-held corporations and personal service corporations can deduct losses from passive activities, which are generally activities in which the taxpayer does not materially participate, only to the extent of the taxpayer's income from those passive activities. The passive loss limitations are applied separately with respect to each publicly-traded partnership. Consequently, any losses we generate will only be available to offset our passive income generated in the future and will not be available to offset income from other passive activities or investments, including our investments or investments in other publicly-traded partnerships, or salary or active business income. Passive losses that are not deductible because they exceed a unitholder's share of income we generate may be deducted in full when he disposes of his entire investment in us in a fully taxable transaction with an unrelated party. The passive activity loss rules are applied after other applicable limitations on deductions, including the at risk rules and the basis limitation.

A unitholder's share of our net income may be offset by any suspended passive losses, but it may not be offset by any other current or carryover losses from other passive activities, including those attributable to other publicly-traded partnerships.

*Limitations on Interest Deductions.* The deductibility of a non-corporate taxpayer's investment interest expense is generally limited to the amount of that taxpayer's net investment income. The IRS has indicated that net passive income from a publicly-traded partnership constitutes investment income for purposes of the limitations on the deductibility of investment interest. In addition, the unitholder's share of our portfolio income will be treated as investment income. Investment interest expense includes:

- (a) interest on indebtedness properly allocable to property held for investment;
  
- (b) our interest expense attributed to portfolio income; and

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**Table of Contents**

**Index to Financial Statements**

(c) the portion of interest expense incurred to purchase or carry an interest in a passive activity to the extent attributable to portfolio income.

The computation of a unitholder's investment interest expense will take into account interest on any margin account borrowing or other loan incurred to purchase or carry a unit. Net investment income includes gross income from property held for investment and amounts treated as portfolio income under the passive loss rules, less deductible expenses, other than interest, directly connected with the production of investment income, but generally does not include gains attributable to the disposition of property held for investment.

*Entity-Level Collections.* If we are required or elect under applicable law to pay any federal, state or local income tax on behalf of any unitholder or the general partner or any former unitholder, we are authorized to pay those taxes from our funds. That payment, if made, will be treated as a distribution of cash to the partner on whose behalf the payment was made. If the payment is made on behalf of a person whose identity cannot be determined, we are authorized to treat the payment as a distribution to all current unitholders. We are authorized to amend the partnership agreement in the manner necessary to maintain uniformity of intrinsic tax characteristics of units and to adjust later distributions, so that after giving effect to these distributions, the priority and characterization of distributions otherwise applicable under the partnership agreement is maintained as nearly as is practicable. Payments by us as described above could give rise to an overpayment of tax on behalf of an individual partner in which event the partner would be required to file a claim in order to obtain a credit or refund.

*Allocation of Income, Gain, Loss and Deduction.* In general, if we have a net profit, our items of income, gain, loss and deduction will be allocated among the general partner and the unitholders in accordance with their percentage interests in us. At any time that incentive distributions are made to the general partner, gross income will be allocated to the general partner to the extent of these distributions. If we have a net loss for the entire year, that loss will be allocated first to the general partner and the unitholders in accordance with their percentage interests in us to the extent of their positive capital accounts and, second, to the general partner.

Specified items of our income, gain, loss and deduction will be allocated to account for the difference between the tax basis and fair market value of our assets at the time of an offering, referred to in this discussion as *Contributed Property*. The effect of these allocations to a unitholder purchasing common units in our offering will be essentially the same as if the tax basis of our assets were equal to their fair market value at the time of the offering. In addition, items of recapture income will be allocated to the extent possible to the partner who was allocated the deduction giving rise to the treatment of that gain as recapture income in order to minimize the recognition of ordinary income by some unitholders. Finally, although we do not expect that our operations will result in the creation of negative capital accounts, if negative capital accounts nevertheless result, items of our income and gain will be allocated in an amount and manner to eliminate the negative balance as quickly as possible.

An allocation of items of our income, gain, loss or deduction, other than an allocation required by the Internal Revenue Code to eliminate the difference between a partner's book capital account, credited with the fair market value of *Contributed Property*, and tax capital account, credited with the tax basis of *Contributed Property*, referred to in this discussion as the *Book-Tax Disparity*, will generally be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction only if the allocation has substantial economic effect. In any other case, a partner's share of an item will be determined on the basis of his interest in us, which will be determined by taking into account all the facts and circumstances,

**Table of Contents**

**Index to Financial Statements**

including his relative contributions to us, the interests of all the partners in profits and losses, the interest of all the partners in cash flow and other nonliquidating distributions and rights of all the partners to distributions of capital upon liquidation.

Vinson & Elkins L.L.P. is of the opinion that, with the exception of the issues described in *Tax Consequences of Unit Ownership* Section 754 Election and *Disposition of Common Units* Allocations Between Transferors and Transferees, allocations under our partnership agreement will be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction.

*Treatment of Short Sales.* A unitholder whose units are loaned to a short seller to cover a short sale of units may be considered as having disposed of those units. If so, he would no longer be a partner for those units during the period of the loan and may recognize gain or loss from the disposition. As a result, during this period:

(a) any of our income, gain, loss or deduction with respect to those units would not be reportable by the unitholder;

(b) any cash distributions received by the unitholder as to those units would be fully taxable; and

(c) all of these distributions would appear to be ordinary income.

Vinson & Elkins L.L.P. has not rendered an opinion regarding the treatment of a unitholder where common units are loaned to a short seller to cover a short sale of common units; therefore, unitholders desiring to assure their status as partners and avoid the risk of gain recognition from a loan to a short seller should modify any applicable brokerage account agreements to prohibit their brokers from borrowing their units. The IRS has announced that it is actively studying issues relating to the tax treatment of short sales of partnership interests. Please also read *Disposition of Common Units* Recognition of Gain or Loss.

*Alternative Minimum Tax.* Each unitholder will be required to take into account his distributive share of any items of our income, gain, loss or deduction for purposes of the alternative minimum tax. The current minimum tax rate for noncorporate taxpayers is 26% on the first \$175,000 of alternative minimum taxable income in excess of the exemption amount and 28% on any additional alternative minimum taxable income. Prospective unitholders should consult with their tax advisors as to the impact of an investment in units on their liability for the alternative minimum tax.

*Tax Rates.* In general, the highest effective United States federal income tax rate for individuals currently is 35% and the maximum United States federal income tax rate for net capital gains of an individual is 15% if the asset disposed of was held for more than 12 months at the time of disposition.

*Section 754 Election.* We have made the election permitted by Section 754 of the Internal Revenue Code. That election is irrevocable without the consent of the IRS. The election will generally permit us to adjust a common unit purchaser's tax basis in our assets (inside basis) under

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Section 743(b) of the Internal Revenue Code to reflect his purchase price. This election does not apply to a person who purchases common units directly from us. The Section 743(b) adjustment belongs to the purchaser and not to other partners. For purposes

- 146 -

**Table of Contents**

**Index to Financial Statements**

of this discussion, a partner's inside basis in our assets will be considered to have two components: (1) his share of our tax basis in our assets (common basis) and (2) his Section 743(b) adjustment to that basis.

Treasury regulations under Section 743 of the Internal Revenue Code require, if the remedial allocation method is adopted (which we have adopted), a portion of the Section 743(b) adjustment attributable to recovery property to be depreciated over the remaining cost recovery period for the Section 704(c) built-in gain. Under Treasury Regulation Section 1.167(c)-1(a)(6), a Section 743(b) adjustment attributable to property subject to depreciation under Section 167 of the Internal Revenue Code rather than cost recovery deductions under Section 168 is generally required to be depreciated using either the straight-line method or the 150% declining balance method. Under our partnership agreement, the general partner is authorized to take a position to preserve the uniformity of units even if that position is not consistent with these Treasury regulations. Please read Uniformity of Units.

Although Vinson & Elkins L.L.P. is unable to opine as to the validity of this approach because there is no clear authority on this issue, we intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the common basis of the property, or treat that portion as non-amortizable to the extent attributable to property the common basis of which is not amortizable. This method is consistent with the regulations under Section 743 but is arguably inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. To the extent this Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury regulations and legislative history. If we determine that this position cannot reasonably be taken, we may take a depreciation or amortization position under which all purchasers acquiring units in the same month would receive depreciation or amortization, whether attributable to common basis or a Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our assets. This kind of aggregate approach may result in lower annual depreciation or amortization deductions than would otherwise be allowable to some unitholders. Please read Uniformity of Units.

A Section 754 election is advantageous if the transferee's tax basis in his units is higher than the units' share of the aggregate tax basis of our assets immediately prior to the transfer. In that case, as a result of the election, the transferee would have, among other items, a greater amount of depreciation and depletion deductions and his share of any gain on a sale of our assets would be less. Conversely, a Section 754 election is disadvantageous if the transferee's tax basis in his units is lower than those units' share of the aggregate tax basis of our assets immediately prior to the transfer. Thus, the fair market value of the units may be affected either favorably or unfavorably by the election.

The calculations involved in the Section 754 election are complex and will be made on the basis of assumptions as to the value of our assets and other matters. For example, the allocation of the Section 743(b) adjustment among our assets must be made in accordance with the Internal Revenue Code. The IRS could seek to reallocate some or all of any Section 743(b) adjustment we allocated to our tangible assets to goodwill instead. Goodwill, as an intangible asset, is generally amortizable over a longer period of time or under a less accelerated method than our tangible assets. We cannot assure you that the determinations we make will not be successfully challenged by the IRS and that the deductions resulting from them will not be reduced or disallowed altogether. Should the IRS require a different basis adjustment to be made, and should, in our opinion, the expense of compliance exceed the benefit of the election, we may seek permission from the IRS to



**Table of Contents**

**Index to Financial Statements**

revoke our Section 754 election. If permission is granted, a subsequent purchaser of units may be allocated more income than he would have been allocated had the election not been revoked.

**Tax Treatment of Operations**

*Accounting Method and Taxable Year.* We use the year ending December 31 as our taxable year and the accrual method of accounting for federal income tax purposes. Each unitholder will be required to include in income his share of our income, gain, loss and deduction for our taxable year ending within or with his taxable year.

*Tax Basis, Depreciation and Amortization.* The tax basis of our assets will be used for purposes of computing depreciation and cost recovery deductions and, ultimately, gain or loss on the disposition of these assets. The federal income tax burden associated with the difference between the fair market value of our assets and their tax basis immediately prior to an offering will be borne by the general partner, its affiliates and our other unitholders as of that time. Please read Allocation of Income, Gain, Loss and Deduction.

To the extent allowable, we may elect to use the depreciation and cost recovery methods that will result in the largest deductions being taken in the early years after assets are placed in service. We are not entitled to any amortization deductions with respect to any goodwill conveyed to us on formation. Property we subsequently acquire or construct may be depreciated using accelerated methods permitted by the Internal Revenue Code.

If we dispose of depreciable property by sale, foreclosure, or otherwise, all or a portion of any gain, determined by reference to the amount of depreciation previously deducted and the nature of the property, may be subject to the recapture rules and taxed as ordinary income rather than capital gain. Similarly, a partner who has taken cost recovery or depreciation deductions with respect to property we own will likely be required to recapture some or all of those deductions as ordinary income upon a sale of his interest in us. Please read Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction and Disposition of Common Units Recognition of Gain or Loss.

The costs incurred in selling our units (called syndication expenses ) must be capitalized and cannot be deducted currently, ratably or upon our termination. There are uncertainties regarding the classification of costs as organization expenses, which we may amortize, and as syndication expenses, which we may not amortize. The underwriting discounts and commissions we incur will be treated as syndication expenses.

*Valuation and Tax Basis of Our Properties.* The federal income tax consequences of the ownership and disposition of units will depend in part on our estimates of the relative fair market values, and the initial tax bases, of our assets. Although we may from time to time consult with professional appraisers regarding valuation matters, we will make many of the relative fair market value estimates ourselves. These estimates of basis are subject to challenge and will not be binding on the IRS or the courts. If the estimates of fair market value or basis are later found to be incorrect, the character and amount of items of income, gain, loss or deductions previously reported by unitholders might change, and unitholders might be required to adjust their tax liability for prior years and incur interest and penalties with respect to those adjustments.

**Table of Contents**

**Index to Financial Statements**

**Disposition of Common Units**

*Recognition of Gain or Loss.* Gain or loss will be recognized on a sale of units equal to the difference between the amount realized and the unitholder's tax basis for the units sold. A unitholder's amount realized will be measured by the sum of the cash or the fair market value of other property he receives plus his share of our nonrecourse liabilities. Because the amount realized includes a unitholder's share of our nonrecourse liabilities, the gain recognized on the sale of units could result in a tax liability in excess of any cash received from the sale.

Prior distributions from us in excess of cumulative net taxable income for a common unit that decreased a unitholder's tax basis in that common unit will, in effect, become taxable income if the common unit is sold at a price greater than the unitholder's tax basis in that common unit, even if the price received is less than his original cost.

Except as noted below, gain or loss recognized by a unitholder, other than a dealer in units, on the sale or exchange of a unit held for more than one year will generally be taxable as capital gain or loss. Capital gain recognized by an individual on the sale of units held more than 12 months will generally be taxed at a maximum rate of 15%. A portion of this gain or loss, which will likely be substantial, however, will be separately computed and taxed as ordinary income or loss under Section 751 of the Internal Revenue Code to the extent attributable to assets giving rise to depreciation recapture or other unrealized receivables or to inventory items we own. The term unrealized receivables includes potential recapture items, including depreciation recapture. Ordinary income attributable to unrealized receivables, inventory items and depreciation recapture may exceed net taxable gain realized upon the sale of a unit and may be recognized even if there is a net taxable loss realized on the sale of a unit. Thus, a unitholder may recognize both ordinary income and a capital loss upon a sale of units. Net capital loss may offset capital gains and no more than \$3,000 of ordinary income, in the case of individuals, and may only be used to offset capital gain in the case of corporations.

The IRS has ruled that a partner who acquires interests in a partnership in separate transactions must combine those interests and maintain a single adjusted tax basis for all those interests. Upon a sale or other disposition of less than all of those interests, a portion of that tax basis must be allocated to the interests sold using an equitable apportionment method. Treasury regulations allow a selling unitholder who can identify common units transferred with an ascertainable holding period to elect to use the actual holding period of the common units transferred. Thus, according to the ruling, a common unitholder will be unable to select high or low basis common units to sell as would be the case with corporate stock, but, according to the regulations, may designate specific common units sold for purposes of determining the holding period of units transferred. A unitholder electing to use the actual holding period of common units transferred must consistently use that identification method for all subsequent sales or exchanges of common units. A unitholder considering the purchase of additional units or a sale of common units purchased in separate transactions should consult his tax advisor as to the possible consequences of this ruling and application of the Treasury regulations.

Specific provisions of the Internal Revenue Code affect the taxation of some financial products and securities, including partnership interests, by treating a taxpayer as having sold an appreciated partnership interest, one in which gain would be recognized if it were sold, assigned or terminated at its fair market value, if the taxpayer or related persons enter(s) into:

(a) a short sale;

(b) an offsetting notional principal contract; or

- 149 -

**Table of Contents**

**Index to Financial Statements**

(c) a futures or forward contract with respect to the partnership interest or substantially identical property.

Moreover, if a taxpayer has previously entered into a short sale, an offsetting notional principal contract or a futures or forward contract with respect to the partnership interest, the taxpayer will be treated as having sold that position if the taxpayer or a related person then acquires the partnership interest or substantially identical property. The Secretary of Treasury is also authorized to issue regulations that treat a taxpayer that enters into transactions or positions that have substantially the same effect as the preceding transactions as having constructively sold the financial position.

*Allocations Between Transferors and Transferees.* In general, our taxable income and losses will be determined annually, will be prorated on a monthly basis and will be subsequently apportioned among the unitholders in proportion to the number of units owned by each of them as of the opening of the applicable exchange on the first business day of the month (the Allocation Date ). However, gain or loss realized on a sale or other disposition of our assets other than in the ordinary course of business will be allocated among the unitholders on the Allocation Date in the month in which that gain or loss is recognized. As a result, a unitholder transferring units may be allocated income, gain, loss and deduction realized after the date of transfer.

The use of this method may not be permitted under existing Treasury regulations. Accordingly, Vinson & Elkins L.L.P. is unable to opine on the validity of this method of allocating income and deductions between unitholders. If this method is not allowed under the Treasury regulations, or only applies to transfers of less than all of the unitholder's interest, our taxable income or losses might be reallocated among the unitholders. We are authorized to revise our method of allocation between unitholders to conform to a method permitted under future Treasury regulations.

A unitholder who owns units at any time during a quarter and who disposes of them prior to the record date set for a cash distribution for that quarter will be allocated items of our income, gain, loss and deductions attributable to that quarter but will not be entitled to receive that cash distribution.

*Notification Requirements.* A purchaser of units from another unitholder is required to notify us in writing of that purchase within 30 days after the purchase. We are required to notify the IRS of that transaction and to furnish specified information to the transferor and transferee. However, these reporting requirements do not apply to a sale by an individual who is a citizen of the United States and who effects the sale or exchange through a broker. Additionally, a transferor and a transferee of a unit will be required to furnish statements to the IRS, filed with their income tax returns for the taxable year in which the sale or exchange occurred, that describe the amount of the consideration received for the unit that is allocated to our goodwill or going concern value.

*Constructive Termination.* We will be considered to have been terminated for tax purposes if there is a sale or exchange of 50% or more of the total interests in our capital and profits within a 12-month period. A constructive termination results in the closing of our taxable year for all unitholders. We would be required to make new tax elections after a termination, including a new election under Section 754 of the Internal Revenue Code, and a termination would result in a deferral of our deductions for depreciation. A termination could also result in penalties if we were unable to determine that the termination had occurred. Moreover, a termination might either accelerate the application of, or subject us to, any tax legislation enacted before the termination.

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**Table of Contents**

**Index to Financial Statements**

**Uniformity of Units**

Because we cannot match transferors and transferees of units, we must maintain uniformity of the economic and tax characteristics of the units to a purchaser of these units. In the absence of uniformity, we may be unable to completely comply with a number of federal income tax requirements, both statutory and regulatory. A lack of uniformity can result from a literal application of Treasury Regulation Section 1.167(c)-1(a)(6). Any non-uniformity could have a negative impact on the value of the units. Please read Tax Consequences of Unit Ownership Section 754 Election.

We intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the common basis of that property, or treat that portion as nonamortizable, to the extent attributable to property the common basis of which is not amortizable, consistent with the regulations under Section 743, even though that position may be inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6) which is not expected to directly apply to a material portion of our assets. Please read Tax Consequences of Unit Ownership Section 754 Election. To the extent that the Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury regulations and legislative history. If we determine that this position cannot reasonably be taken, we may adopt a depreciation and amortization position under which all purchasers acquiring units in the same month would receive depreciation and amortization deductions, whether attributable to a common basis or Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our property. If this position is adopted, it may result in lower annual depreciation and amortization deductions than would otherwise be allowable to some unitholders and risk the loss of depreciation and amortization deductions not taken in the year that these deductions are otherwise allowable. This position will not be adopted if we determine that the loss of depreciation and amortization deductions will have a material adverse effect on the unitholders. If we choose not to utilize this aggregate method, we may use any other reasonable depreciation and amortization method to preserve the uniformity of the intrinsic tax characteristics of any units that would not have a material adverse effect on the unitholders. The IRS may challenge any method of depreciating the Section 743(b) adjustment described in this paragraph. If this challenge were sustained, the uniformity of units might be affected, and the gain from the sale of units might be increased without the benefit of additional deductions. Please read Disposition of Common Units Recognition of Gain or Loss.

**Tax-Exempt Organizations and Other Investors**

Ownership of units by employee benefit plans, other tax-exempt organizations, non-resident aliens, foreign corporations, other foreign persons and regulated investment companies raises issues unique to those investors and, as described below, may have substantially adverse tax consequences to them.

Employee benefit plans and most other organizations exempt from federal income tax, including individual retirement accounts and other retirement plans, are subject to federal income tax on unrelated business taxable income. Virtually all of our income allocated to a unitholder which is a tax-exempt organization will be unrelated business taxable income and will be taxable to them.

**Table of Contents**

**Index to Financial Statements**

A regulated investment company or mutual fund is required to derive 90% or more of its gross income from interest, dividends and gains from the sale of stocks or securities or foreign currency or specified related sources. It is not anticipated that any significant amount of our gross income will include that type of income.

Non-resident aliens and foreign corporations, trusts or estates that own units will be considered to be engaged in business in the United States because of the ownership of units. As a consequence they will be required to file federal tax returns to report their share of our income, gain, loss or deduction and pay federal income tax at regular rates on their share of our net income or gain. And, under rules applicable to publicly traded partnerships, we will withhold tax, at the highest applicable rate, from cash distributions made quarterly to foreign unitholders. Each foreign unitholder must obtain a taxpayer identification number from the IRS and submit that number to our transfer agent on a Form W-8 BEN or applicable substitute form in order to obtain credit for these withholding taxes.

In addition, because a foreign corporation that owns units will be treated as engaged in a United States trade or business, that corporation may be subject to the United States branch profits tax at a rate of 30%, in addition to regular federal income tax, on its share of our income and gain, as adjusted for changes in the foreign corporation's U.S. net equity, which are effectively connected with the conduct of a United States trade or business. That tax may be reduced or eliminated by an income tax treaty between the United States and the country in which the foreign corporate unitholder is a qualified resident. In addition, this type of unitholder is subject to special information reporting requirements under Section 6038C of the Internal Revenue Code.

Under a ruling of the IRS, a foreign unitholder who sells or otherwise disposes of a unit will be subject to federal income tax on gain realized on the sale or disposition of that unit to the extent that this gain is effectively connected with a United States trade or business of the foreign unitholder. Apart from the ruling, a foreign unitholder will not be taxed or subject to withholding upon the sale or disposition of a unit if he has owned less than 5% in value of the units during the five-year period ending on the date of the disposition and if the units are regularly traded on an established securities market at the time of the sale or disposition.

**Table of Contents**

**Index to Financial Statements**

(ii) Administrative Matters

*Information Returns and Audit Procedures.* We intend to furnish to each unitholder, within 90 days after the close of each calendar year, specific tax information, including a Schedule K-1, which describes his share of our income, gain, loss and deduction for our preceding taxable year. In preparing this information, which will not be reviewed by counsel, we will take various accounting and reporting positions, some of which have been mentioned earlier, to determine his share of income, gain, loss and deduction. We cannot assure you that those positions will yield a result that conforms to the requirements of the Internal Revenue Code, regulations or administrative interpretations of the IRS. Neither we nor counsel can assure prospective unitholders that the IRS will not successfully contend in court that those positions are impermissible. Any challenge by the IRS could negatively affect the value of the units.

The IRS may audit our federal income tax information returns. Adjustments resulting from an IRS audit may require each unitholder to adjust a prior year's tax liability, and possibly may result in an audit of his own return. Any audit of a unitholder's return could result in adjustments not related to our returns as well as those related to our returns.

Partnerships generally are treated as separate entities for purposes of federal tax audits, judicial review of administrative adjustments by the IRS and tax settlement proceedings. The tax treatment of partnership items of income, gain, loss and deduction are determined in a partnership proceeding rather than in separate proceedings with the partners. The Internal Revenue Code requires that one partner be designated as the Tax Matters Partner for these purposes. The partnership agreement names the general partner as our Tax Matters Partner.

The Tax Matters Partner will make some elections on our behalf and on behalf of unitholders. In addition, the Tax Matters Partner can extend the statute of limitations for assessment of tax deficiencies against unitholders for items in our returns. The Tax Matters Partner may bind a unitholder with less than a 1% profits interest in us to a settlement with the IRS unless that unitholder elects, by filing a statement with the IRS, not to give that authority to the Tax Matters Partner. The Tax Matters Partner may seek judicial review, by which all the unitholders are bound, of a final partnership administrative adjustment and, if the Tax Matters Partner fails to seek judicial review, judicial review may be sought by any unitholder having at least a 1% interest in profits or by any group of unitholders having in the aggregate at least a 5% interest in profits. However, only one action for judicial review will go forward, and each unitholder with an interest in the outcome may participate.

A unitholder must file a statement with the IRS identifying the treatment of any item on his federal income tax return that is not consistent with the treatment of the item on our return. Intentional or negligent disregard of this consistency requirement may subject a unitholder to substantial penalties.

*Nominee Reporting.* Persons who hold an interest in us as a nominee for another person are required to furnish to us:

(a) the name, address and taxpayer identification number of the beneficial owner and the nominee;

(b) whether the beneficial owner is

(i) a person that is not a United States person,

(ii) a foreign government, an international organization or any wholly owned agency or instrumentality of either of the foregoing, or

(iii) a tax-exempt entity;

- 153 -



**Table of Contents**

**Index to Financial Statements**

(c) the amount and description of units held, acquired or transferred for the beneficial owner; and

(d) specific information including the dates of acquisitions and transfers, means of acquisitions and transfers, and acquisition cost for purchases, as well as the amount of net proceeds from sales.

Brokers and financial institutions are required to furnish additional information, including whether they are United States persons and specific information on units they acquire, hold or transfer for their own account. A penalty of \$50 per failure, up to a maximum of \$100,000 per calendar year, is imposed by the Internal Revenue Code for failure to report that information to us. The nominee is required to supply the beneficial owner of the units with the information furnished to us.

*Registration as a Tax Shelter.* The Internal Revenue Code requires that tax shelters be registered with the Secretary of the Treasury. It is arguable that we are not subject to the registration requirement on the basis that we will not constitute a tax shelter. However, we have registered as a tax shelter with the Secretary of Treasury in the absence of assurance that we will not be subject to tax shelter registration and in light of the substantial penalties which might be imposed if registration is required and not undertaken.

**Our tax shelter registration number is 96234000014.**

**Issuance of this registration number does not indicate that investment in us or the claimed tax benefits have been reviewed, examined or approved by the IRS.**

A unitholder who sells or otherwise transfers a unit in a later transaction must furnish the registration number to the transferee. The penalty for failure of the transferor of a unit to furnish the registration number to the transferee is \$100 for each failure. The unitholders must disclose our tax shelter registration number on Form 8271 to be attached to the tax return on which any deduction, loss or other benefit we generate is claimed or on which any of our income is included. A unitholder who fails to disclose the tax shelter registration number on his return, without reasonable cause for that failure, will be subject to a \$250 penalty for each failure. Any penalties discussed are not deductible for federal income tax purposes.

Recently issued Treasury Regulations require taxpayers to report certain information on Internal Revenue Service Form 8886 if they participate in a reportable transaction. You may be required to file this form with the IRS if we participate in a reportable transaction. A transaction may be a reportable transaction based upon any of several factors. You are urged to consult with your own tax advisor concerning the application of any of these factors to your investment in our common units. Congress is considering legislative proposals that, if enacted, would impose significant penalties for failure to comply with these disclosure requirements. The Treasury Regulations also impose obligations on material advisors that organize, manage or sell interests in registered tax shelters. As stated above, we have registered as a tax shelter, and, thus, one of our material advisors will be required to maintain a list with specific information, including your name and tax identification number, and to furnish this information to the IRS upon request. You are urged to consult with your own tax advisor concerning any possible disclosure obligation with respect to your investment and should be aware that we and our material advisors intend to comply with the list and disclosure requirements.

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*Accuracy-related Penalties.* An additional tax equal to 20% of the amount of any portion of an underpayment of tax that is attributable to one or more specified causes, including negligence or disregard of rules or regulations, substantial understatements of income tax and substantial valuation misstatements, is imposed by the Internal Revenue Code. No penalty will be imposed, however, for any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith regarding that portion.

- 154 -

**Table of Contents**

**Index to Financial Statements**

A substantial understatement of income tax in any taxable year exists if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 for most corporations). The amount of any understatement subject to penalty generally is reduced if any portion is attributable to a position adopted on the return:

(a) for which there is, or was, substantial authority, or

(b) as to which there is a reasonable basis and the pertinent facts of that position are disclosed on the return.

More stringent rules apply for purposes of reducing the amount of any understatement attributable to a tax shelter, a term that in the context of the substantial understatement penalty does not appear to include us, even though we are a registered tax shelter. If any item of income, gain, loss or deduction included in the distributive shares of unitholders might result in that kind of an understatement of income for which no substantial authority exists, we must disclose the pertinent facts on our return. In addition, we will make a reasonable effort to furnish sufficient information for unitholders to make adequate disclosure on their returns to avoid liability for this penalty.

A substantial valuation misstatement exists if the value of any property, or the adjusted basis of any property, claimed on a tax return is 200% or more of the amount determined to be the correct amount of the valuation or adjusted basis. No penalty is imposed unless the portion of the underpayment attributable to a substantial valuation misstatement exceeds \$5,000 (\$10,000 for most corporations). If the valuation claimed on a return is 400% or more than the correct valuation, the penalty imposed increases to 40%.

**State, Local and Other Tax Considerations**

In addition to federal income taxes, you will be subject to other taxes, including state and local income taxes, unincorporated business taxes, and estate, inheritance or intangible taxes that may be imposed by the various jurisdictions in which we do business or own property or in which you are a resident. We currently do business or own property in 29 states, most of which impose income taxes. We may also own property or do business in other states or foreign jurisdictions in the future. Although an analysis of those various taxes is not presented here, each prospective unitholder should consider their potential impact on his investment in us. You may not be required to file a return and pay taxes in some states because your income from that state falls below the filing and payment requirement. You will be required, however, to file state income tax returns and to pay state income taxes in many of the states in which we do business or own property, and you may be subject to penalties for failure to comply with those requirements. In some states, tax losses may not produce a tax benefit in the year incurred and also may not be available to offset income in subsequent taxable years. Some of the states may require us, or we may elect, to withhold a percentage of income from amounts to be distributed to a unitholder who is not a resident of the state. Withholding, the amount of which may be greater or less than a particular unitholder's income tax liability to the state, generally does not relieve a nonresident unitholder from the obligation to file an income tax return. Amounts withheld may be treated as if distributed to unitholders for purposes of determining the amounts distributed by us. Please read Tax Consequences of Unit Ownership Entity-Level Collections. Based on current law and our estimate of our future operations, the general partner anticipates that any amounts required to be withheld will not be material.

**Table of Contents**

**Index to Financial Statements**

**It is the responsibility of each unitholder to investigate the legal and tax consequences, under the laws of pertinent states and localities, of his investment in us. Accordingly, each prospective unitholder is urged to consult with, and depend upon, his own tax counsel or other advisor with regard to those matters. Further, it is the responsibility of each unitholder to file all state and local, as well as United States federal tax returns, that may be required of him. Vinson & Elkins L.L.P. has not rendered an opinion on the state or local tax consequences of an investment in us.**

**Tax Consequences of Ownership of Debt Securities**

A description of the material federal income tax consequences of the acquisition, ownership and disposition of debt securities will be set forth on the prospectus supplement relating to the offering of debt securities.

- 156 -

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**Table of Contents**

**Index to Financial Statements**

**INVESTMENT IN US BY EMPLOYEE BENEFIT PLANS**

An investment in us by an employee benefit plan is subject to certain additional considerations because the investments of such plans are subject to the fiduciary responsibility and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended ( ERISA ), and restrictions imposed by Section 4975 of the Internal Revenue Code. As used herein, the term employee benefit plan includes, but is not limited to, qualified pension, profit-sharing and stock bonus plans, Keogh plans, simplified employee pension plans and tax deferred annuities or IRAs established or maintained by an employer or employee organization. Among other things, consideration should be given to (a) whether such investment is prudent under Section 404(a)(1)(B) of ERISA; (b) whether in making such investment, such plan will satisfy the diversification requirement of Section 404(a)(1)(C) of ERISA; and (c) whether such investment will result in recognition of unrelated business taxable income by such plan and, if so, the potential after-tax investment return. Please read Tax Considerations Tax-Exempt Organizations and Other Investors. The person with investment discretion with respect to the assets of an employee benefit plan (a fiduciary ) should determine whether an investment in us is authorized by the appropriate governing instrument and is a proper investment for such plan.

Section 406 of ERISA and Section 4975 of the Internal Revenue Code (which also applies to IRAs that are not considered part of an employee benefit plan) prohibit an employee benefit plan from engaging in certain transactions involving plan assets with parties that are parties in interest under ERISA or disqualified persons under the Internal Revenue Code with respect to the plan.

In addition to considering whether the purchase of limited partnership units is a prohibited transaction, a fiduciary of an employee benefit plan should consider whether such plan will, by investing in us, be deemed to own an undivided interest in our assets, with the result that our general partner also would be a fiduciary of such plan and our operations would be subject to the regulatory restrictions of ERISA, including its prohibited transaction rules, as well as the prohibited transaction rules of the Internal Revenue Code.

The Department of Labor regulations provide guidance with respect to whether the assets of an entity in which employee benefit plans acquire equity interests would be deemed plan assets under certain circumstances. Pursuant to these regulations, an entity's assets would not be considered to be plan assets if, among other things, (a) the equity interest acquired by employee benefit plans are publicly offered securities i.e., the equity interests are widely held by 100 or more investors independent of the issuer and each other, freely transferable and registered pursuant to certain provisions of the federal securities laws, (b) the entity is an Operating Partnership i.e., it is primarily engaged in the production or sale of a product or service other than the investment of capital either directly or through a majority owned subsidiary or subsidiaries, or (c) there is no significant investment by benefit plan investors, which is defined to mean that less than 25% of the value of each class of equity interest (disregarding certain interests held by our general partner, its affiliates and certain other persons) is held by the employee benefit plans referred to above, IRAs and other employee benefit plans not subject to ERISA (such as governmental plans). Our assets should not be considered plan assets under these regulations because it is expected that the investment will satisfy the requirements in (a) and (b) above and may also satisfy the requirements in (c) above.

Plan fiduciaries contemplating a purchase of limited partnership units should consult with their own counsel regarding the consequences under ERISA and the Internal Revenue Code in light of the serious penalties imposed on persons who engage in prohibited transactions or other violations.

**Table of Contents**

**Index to Financial Statements**

**PLAN OF DISTRIBUTION**

We may sell the securities being offered hereby directly to purchasers, through agents, through underwriters or through dealers.

We, or agents designated by us, may directly solicit, from time to time, offers to purchase the securities. Any such agent may be deemed to be an underwriter as that term is defined in the Securities Act of 1933. We will name the agents involved in the offer or sale of the securities and describe any commissions payable by us to these agents in the prospectus supplement. Unless otherwise indicated in the prospectus supplement, these agents will be acting on a best efforts basis for the period of their appointment. The agents may be entitled under agreements which may be entered into with us to indemnification by us against specific civil liabilities, including liabilities under the Securities Act of 1933. The agents may also be our customers or may engage in transactions with or perform services for us in the ordinary course of business.

If we utilize any underwriters in the sale of the securities in respect of which this prospectus is delivered, we will enter into an underwriting agreement with those underwriters at the time of sale to them. We will set forth the names of these underwriters and the terms of the transaction in the prospectus supplement, which will be used by the underwriters to make resales of the securities in respect of which this prospectus is delivered to the public. We may indemnify the underwriters under the relevant underwriting agreement to indemnification by us against specific liabilities, including liabilities under the Securities Act. The underwriters may also be our customers or may engage in transactions with or perform services for us in the ordinary course of business.

If we utilize a dealer in the sale of the securities in respect of which this prospectus is delivered, we will sell those securities to the dealer, as principal. The dealer may then resell those securities to the public at varying prices to be determined by the dealer at the time of resale. We may indemnify the dealers against specific liabilities, including liabilities under the Securities Act. The dealers may also be our customers or may engage in transactions with, or perform services for us in the ordinary course of business.

Common units and debt securities may also be sold directly by us. In this case, no underwriters or agents would be involved. We may use electronic media, including the Internet, to sell offered securities directly.

To the extent required, this prospectus may be amended or supplemented from time to time to describe a specific plan of distribution. The place and time of delivery for the securities in respect of which this prospectus is delivered are set forth in the accompanying prospectus supplement.

**Distribution by Selling Unitholders**

Distribution of any common units to be offered by one or more of the selling unitholders may be effected from time to time in one or more transactions (which may involve block transactions) (1) on the New York Stock Exchange, (2) in the over-the-counter market, (3) in underwritten transactions, (4) in transactions otherwise than on the New York Stock Exchange or in the over-the-counter market or (5) in a combination of any of these transactions. The transactions may be effected by the selling unitholders at market prices prevailing at the time of

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sale, at prices related to the prevailing market prices, at negotiated prices or at fixed prices. The selling unitholders may offer their shares through underwriters, brokers, dealers or agents, who may receive compensation in the form of underwriting discounts, commissions or concessions from the selling unitholders and/or the purchasers of the shares for whom they act as agent. The selling unitholders may engage in short sales, short sales against the box, puts and calls and other transactions in our securities, or derivatives thereof,

- 158 -

**Table of Contents**

**Index to Financial Statements**

and may sell and deliver their common units in connection therewith. In addition, the selling unitholders may from time to time sell their common units in transactions permitted by Rule 144 under the Securities Act.

As of the date of this prospectus, we have not engaged any underwriter, broker, dealer or agent in connection with the distribution of common units pursuant to this prospectus by the selling unitholders. To the extent required, the number of common units to be sold, the purchase price, the name of any applicable agent, broker, dealer or underwriter and any applicable commissions with respect to a particular offer will be set forth in the applicable prospectus supplement. The aggregate net proceeds to the selling unitholders from the sale of their common units offered hereby will be the sale price of those shares, less any commissions, if any, and other expenses of issuance and distribution not borne by us.

The selling unitholders and any brokers, dealers, agents or underwriters that participate with the selling unitholders in the distribution of shares may be deemed to be underwriters within the meaning of the Securities Act, in which event any discounts, concessions and commissions received by such brokers, dealers, agents or underwriters and any profit on the resale of the shares purchased by them may be deemed to be underwriting discounts and commissions under the Securities Act.

We have agreed to bear the fees and expenses of the selling unitholders, excluding underwriting discounts and commissions and any legal expenses, in connection with the registration of the common units being offered hereby by them. We have also agreed to indemnify the selling unitholders against certain civil liabilities, including liabilities under the Securities Act.

**LEGAL MATTERS**

The validity of the securities offered in this prospectus will be passed upon for us by Vinson & Elkins L.L.P., Houston, Texas and Doerner, Saunders, Daniel & Anderson, L.L.P., Tulsa, Oklahoma. Vinson & Elkins L.L.P. will also render an opinion on the material federal income tax considerations regarding the securities. If certain legal matters in connection with an offering of the securities made by this prospectus and a related prospectus supplement are passed on by counsel for the underwriters of such offering, that counsel will be named in the applicable prospectus supplement related to that offering.

**EXPERTS**

The consolidated financial statements of Heritage Propane Partners, L.P., as of August 31, 2003 and 2002, and for each of the three years in the period ended August 31, 2003, the financial statements of Bi-State Propane as of August 31, 2002 and for the year then ended, the consolidated balance sheet of U.S. Propane, L.P., as of August 31, 2003, and the consolidated balance sheet of U.S. Propane L.L.C., as of August 31, 2003, incorporated by reference in the prospectus and elsewhere in the registration statement of which the prospectus is a part, have been audited by Grant Thornton LLP, independent certified public accountants, as indicated in their reports with respect thereto, and are incorporated by reference in the prospectus in reliance upon the authority of said firm as experts in giving such reports.

The combined financial statements of V-1 Oil Co. and V-1 Gas Co. as of December 31, 2001 and 2000, and for each of the three years in the period ended December 31, 2001, incorporated by reference in this prospectus and elsewhere in the registration statement of which the prospectus is a part, have been audited by Grant Thornton LLP, independent certified public accountants, as indicated in their report with respect



thereto, and are incorporated by reference in the prospectus in reliance upon the authority of said firm as experts in giving such reports.

- 159 -

**Table of Contents**

**Index to Financial Statements**

The consolidated financial statements of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002 and December 31, 2001 and for the periods ended September 30, 2002 and December 31, 2001 and 2000; and the consolidated financial statements of Oasis Pipe Line Company as of December 27, 2002 and the period then ended; and the combined financial statements of Energy Transfer Company as of August 31, 2003 and for the eleven months then ended, appearing in this prospectus supplement have been audited by Ernst & Young LLP, independent auditors, as set forth in their reports thereon appearing elsewhere herein, and are included in reliance upon such reports given on the authority of such firm as experts in accounting and auditing. The audit report covering the consolidated financial statements of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002 and December 31, 2001, and for the periods ended September 30, 2002 and December 31, 2001 and 2000 refers to a change in accounting for goodwill and other intangible assets.

The consolidated financial statements of Oasis Pipe Line Company and subsidiaries as of December 31, 2001 and for the years ended December 31, 2001 and 2000 incorporated in this prospectus by reference from the Current Report on Form 8-K of Heritage Propane Partners, L.P. dated December 17, 2003 have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

**Table of Contents**

**Index to Financial Statements**

**WHERE YOU CAN FIND MORE INFORMATION**

We have filed a registration statement with the SEC under the Securities Act of 1933 that registers the securities offered by this prospectus. The registration statement, including the attached exhibits, contains additional relevant information about us. The rules and regulations of the SEC allow us to omit some information included in the registration statement from this prospectus.

In addition, we file annual, quarterly and other reports and other information with the SEC. You may read and copy any document we file at the SEC's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-732-0330 for further information on the operation of the SEC's public reference room. Our SEC filings are available on the SEC's web site at <http://www.sec.gov>. We also make available free of charge on our website, at <http://www.heritagepropane.com>, all materials that we file electronically with the SEC, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Section 16 reports and amendments to these reports as soon as reasonably practicable after such materials are electronically filed with, or furnished to, the SEC. Additionally, you can obtain information about us through the New York Stock Exchange, 20 Broad Street, New York, New York 10005, on which our common units are listed.

The SEC allows us to incorporate by reference the information we have filed with the SEC. This means that we can disclose important information to you without actually including the specific information in this prospectus by referring you to other documents filed separately with the SEC. These other documents contain important information about us, our financial condition and results of operations. The information incorporated by reference is an important part of this prospectus. Information that we file later with the SEC will automatically update and may replace information in this prospectus and information previously filed with the SEC.

We incorporate by reference in this prospectus the documents listed below:

our annual report on Form 10-K for the year ended August 31, 2003;

our current reports on Form 8-K filed January 6, 2003, March 18, 2003, December 1, 2003, December 10, 2003, December 15, 2003, December 17, 2003, December 19, 2003 and January 9, 2004;

the description of our common units in our registration statement on Form 8-A (File No. 1-11727) filed pursuant to the Securities Exchange Act of 1934 on May 16, 1996; and

all documents filed by us under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 between the date of this prospectus and the termination of the registration statement.

You may obtain any of the documents incorporated by reference in this prospectus from the SEC through the SEC's website at the address provided above. You also may request a copy of any document incorporated by reference in this prospectus (including exhibits to those documents specifically incorporated by reference in this document), at no cost, by visiting our internet website at [www.heritagepropane.com](http://www.heritagepropane.com), or by writing or calling us at the following address:

Energy Transfer Partners, L.P.

8801 South Yale Avenue, Suite 310

Tulsa, Oklahoma 74137

Attention: Michael L. Greenwood

Telephone: (918) 492-7272

- 161 -

**Table of Contents**

**Index to Financial Statements**

**INDEX TO FINANCIAL STATEMENTS**

|  | <b>Page</b> |
|--|-------------|
| Heritage Propane Partners, L.P. Unaudited Pro Forma Combined Financial Statements:   |             |
| <u>Introduction</u>  | F-2         |
| <u>Pro Forma Combined Balance Sheet as of August 31, 2003</u>  | F-4         |
| <u>Pro Forma Combined Statement of Operations for the Year Ended August 31, 2003</u>   | F-5         |
| <u>Notes to Unaudited Pro Forma Combined Financial Statements</u>  | F-6         |
| <u>Summary of La Grange Transaction and Related Pro Forma Financial Statements</u>   | F-11        |
| <u>Energy Transfer Company Unaudited Pro Forma Combined Statement of Operations for the Year Ended August 31, 2003</u>   | F-13        |
| <u>Energy Transfer Company Notes to Unaudited Pro Forma Combined Statement of Operations for the Year Ended August 31, 2003</u>  | F-14        |
| Energy Transfer Company  |             |
| <u>Report of Independent Auditors</u>  | F-16        |
| <u>Combined Balance sheet as of August 31, 2003</u>  | F-17        |
| <u>Combined Income Statement for the period from October 1, 2002 Through August 31, 2003</u>   | F-18        |
| <u>Combined Statement of Partners' Capital for the period from October 1, 2002 Through August 31, 2003</u>   | F-19        |
| <u>Combined Statement of Cash Flows for the Period from October 1, 2002 Through August 31, 2003</u>  | F-20        |
| <u>Notes to Combined Financial Statements</u>  | F-21        |
| Aquila Gas Pipeline Corporation:   |             |
| <u>Report of Independent Auditors</u>  | F-37        |
| <u>Consolidated Balance Sheets as of September 30, 2002 and December 31, 2001</u>  | F-38        |
| <u>Consolidated Statements of Income for the Nine Months Ended September 30, 2002 and the years ended December 31, 2001 and 2000</u>   | F-39        |
| <u>Consolidated Statements of Stockholders' Equity for the Nine Months Ended September 30, 2002 and the Years ended December 31, 2001 and 2000</u>                             | F-40        |
| <u>Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2002 and the Years Ended December 31, 2001 and 2000</u>                                       | F-41        |
| <u>Notes to Consolidated Financial Statements</u>  | F-42        |
| Oasis Pipe Line Company:   |             |
| <u>Report of Independent Auditors</u>  | F-57        |
| <u>Independent Auditors' Report</u>  | F-58        |
| <u>Consolidated Balance Sheets as of December 27, 2002 and December 31, 2001</u>   | F-59        |
| <u>Consolidated Statements of Income for the Period from January 1, 2002 Through December 27, 2002 and the Years Ended December 31, 2001 and 2000</u>                          | F-60        |
| <u>Consolidated Statements of Changes in Shareholders' Equity for the Period From January 1, 2002 Through December 27, 2002 and the Years ended December 31, 2001 and 2000</u> | F-61        |
| <u>Consolidated Statements of Cash Flows for the Period From January 1, 2002 Through December 27, 2002 and the Years Ended December 31, 2001 and 2000</u>                      | F-62        |
| <u>Notes to Consolidated Financial Statements</u>  | F-63        |

Table of Contents

Index to Financial Statements

**HERITAGE PROPANE PARTNERS, L.P.**

**UNAUDITED PRO FORMA COMBINED FINANCIAL STATEMENTS**

**Introduction**

The pro forma financial statements are based upon the combined historical financial position and results of operations of Heritage Propane Partners, L.P. ( Heritage ) and La Grange Acquisition, L.P. which conducts business under the name Energy Transfer Company ( Energy Transfer ). The pro forma financial statements give effect to the following transactions:

In November 2003, Heritage signed a definitive agreement with La Grange Energy, L.P. ( La Grange Energy ) pursuant to which La Grange Energy will contribute its subsidiary Energy Transfer to Heritage in exchange for cash, the assumption of debt and accounts payable and other specified liabilities, Common Units, Class D Units and Special Units of Heritage. Energy Transfer will distribute its cash and accounts receivable to La Grange Energy and an affiliate of La Grange Energy will contribute an office building to Energy Transfer, in each case prior to the contribution of Energy Transfer to Heritage. Simultaneously with this acquisition, La Grange Energy will obtain control of Heritage by acquiring all of the interest in U.S. Propane, L.P., the general partner of Heritage, and U.S. Propane, L.L.C., the general partner of U.S. Propane L.P., from subsidiaries of AGL Resources, Inc., Atmos Energy Corporation, TECO Energy, Inc. and Piedmont Natural Gas Company, Inc. (the Utilities ). Heritage will also acquire all of the common stock of Heritage Holdings, Inc. ( Heritage Holdings ) from the Utilities. The transactions described in this paragraph are collectively referred to as the Energy Transfer Transaction.

Energy Transfer was formed on October 1, 2002, and is owned by its limited partner, La Grange Energy, and its general partner, LA GP, LLC. La Grange Acquisition, L.P. (La Grange Acquisition) is the limited partner of ETC Gas Company, Ltd., ETC Texas Pipeline, Ltd., ETC Processing, Ltd., ETC Marketing, Ltd., ETC Oasis Pipe Line, L.P. and ET Company I, Ltd. (collectively, the Operating Partnerships ). La Grange Acquisition and the Operating Partnerships collectively form Energy Transfer Company. In October 2002, Energy Transfer acquired the Texas and Oklahoma natural gas gathering and gas processing assets of Aquila Gas Pipeline Corporation, a subsidiary of Aquila, Inc., including 50% of the capital stock of Oasis Pipe Line Company ( Oasis Pipe Line ), and a 20% ownership interest in the Nustar Joint Venture. On December 27, 2002, Oasis Pipe Line redeemed the remaining 50% of its capital stock and cancelled the stock, resulting in Energy Transfer owning 100% of Oasis Pipe Line. Energy Transfer contributed the assets acquired from Aquila Gas Pipeline to the Operating Partnerships in return for its limited partner interests in the Operating Partnerships. These transactions are collectively referred to as the La Grange Transactions.

The following pro forma combined financial statements include the following:

the unaudited pro forma balance sheet of Heritage, which gives pro forma effect to the Energy Transfer Transaction as if such transaction occurred on August 31, 2003;

the unaudited pro forma statement of operations of Heritage, which adjusts the pro forma statement of operations of Energy Transfer described below to give pro forma effect to the Energy Transfer Transaction as if such transaction occurred on September 1, 2002;

and

F-2

**Table of Contents**

**Index to Financial Statements**

the unaudited pro forma statement of operations of Energy Transfer, which gives pro forma effect to the La Grange Transactions as if such transactions occurred on September 1, 2002.

**Summary of Energy Transfer Transaction and Related Pro Forma Financial Statements**

The following unaudited pro forma combined financial statements present (i) unaudited pro forma balance sheet data at August 31, 2003, giving effect to the Energy Transfer Transaction as if the Energy Transfer Transaction had been consummated on that date and (ii) unaudited pro forma operating data for the year ended August 31, 2003, giving effect to the Energy Transfer Transaction and the La Grange Transactions as if such transactions had been consummated on September 1, 2002. The unaudited pro forma combined balance sheet data combines the August 31, 2003 balance sheets of Energy Transfer, which is contained elsewhere in this prospectus supplement, Heritage, which is incorporated herein by reference, and Heritage Holdings after giving effect to pro forma adjustments. The unaudited pro forma combined statement of operations for the year ended August 31, 2003, combines the pro forma results of operations for Energy Transfer for the 12 months ended August 31, 2003, contained elsewhere in this prospectus supplement, and the results of operations for Heritage for the 12 months ended August 31, 2003, incorporated herein by reference, and the results of operations for Heritage Holdings after giving effect to pro forma adjustments.

The Energy Transfer Transaction will be accounted for as a reverse acquisition in accordance with Statement of Financial Accounting Standard No. 141. Although Heritage is the surviving parent entity for legal purposes, Energy Transfer will be the acquiror for accounting purposes. The assets and liabilities of Heritage will be reflected at fair value to the extent acquired by Energy Transfer in accordance with EITF 90-13. The assets and liabilities of Energy Transfer will be reflected at historical cost. A final determination of the purchase accounting adjustments, including the allocation of the purchase price to the assets acquired and liabilities assumed based on their respective fair values, has not been made. Accordingly, the purchase accounting adjustments made in connection with the development of the following summary pro forma combined financial statements are preliminary and have been made solely for purposes of developing such pro forma combined financial statements. However, management does not believe that final adjustments will be materially different from the amounts presented herein.

The following unaudited pro forma combined financial statements are provided for informational purposes only and should be read in conjunction with the separate audited combined financial statements of Energy Transfer (which are included elsewhere in this prospectus supplement) and Heritage (which are filed with Heritage's Annual Report filed on Form 10-K with the Securities and Exchange Commission on November 26, 2003 and incorporated herein by reference). The following unaudited pro forma combined financial statements are based on certain assumptions and do not purport to be indicative of the results which actually would have been achieved if the Energy Transfer Transaction and the La Grange Transactions had been consummated on the dates indicated or which may be achieved in the future.



Table of ContentsIndex to Financial Statements**HERITAGE PROPANE PARTNERS, L.P.****UNAUDITED PRO FORMA COMBINED BALANCE SHEET**

August 31, 2003

|   | Energy<br>Transfer | Heritage<br>Propane | Heritage<br>Holdings | Pro Forma<br>Adjustments  | Pro Forma<br>Combined |
|---|--------------------|---------------------|----------------------|---|-----------------------|
| (In thousands)                            |                    |                     |                      |   |                       |
| <b>ASSETS</b>                             |                    |                     |                      |   |                       |
| <b>CURRENT ASSETS:</b>                    |                    |                     |                      |   |                       |
| Cash and cash equivalents                 | \$ 53,122          | \$ 7,117            | \$ 38                | \$ (53,122)(a)<br>271,000(b)<br>292,480(c)<br>(369,220)(d)<br>(5,500)(e)<br>(50,000)(h)<br>14,597(j)<br>(86,780)(k)<br>(1,641)(l) | \$ 72,091             |
| Accounts receivable                       | 105,987            | 35,879              |                      | (105,987)(a)  | 35,879                |
| Inventories and exchanges                 | 3,910              | 45,274              |                      |   | 49,184                |
| Marketable securities and investments     |                    | 3,044               | 913                  |   | 3,957                 |
| Prepaid expenses and other current assets | 20,751             | 2,824               | 4,865                |   | 28,440                |
| <b>Total current assets</b>               | <b>183,770</b>     | <b>94,138</b>       | <b>5,816</b>         | <b>(94,173)</b>   | <b>189,551</b>        |
| PROPERTY, PLANT AND EQUIPMENT, net        | 393,025            | 426,588             |                      | 1,500(a)<br>5,000(d)<br>35,491(f)   | 861,604               |
| INVESTMENT IN AFFILIATES                  | 6,844              | 8,694               |                      | 2,302(f)  | 17,840                |
| NOTE RECEIVABLE                           |                    |                     | 11,539               | (11,539)(g)   |                       |
| INVESTMENT IN HERITAGE PROPANE            |                    |                     | 168,273              | (168,273)(h)  |                       |
| GOODWILL, net                             | 13,409             | 156,595             |                      | 160,853(f)<br>(57,157)(m)   | 273,700               |
| INTANGIBLES AND OTHER ASSETS, net         | 3,645              | 52,824              |                      | 4,000(b)<br>15,096(f)<br>10,688(f)  | 86,253                |
| <b>Total assets</b>                       | <b>\$ 600,693</b>  | <b>\$ 738,839</b>   | <b>\$ 185,628</b>    | <b>\$ (96,212)</b>  | <b>\$ 1,428,948</b>   |
| <b>LIABILITIES AND PARTNERS CAPITAL</b>   |                    |                     |                      |   |                       |
| <b>CURRENT LIABILITIES:</b>               |                    |                     |                      |   |                       |
| Working capital facility                  | \$                 | \$ 26,700           | \$                   | \$  | \$ 26,700             |
| Accounts payable                          | 114,198            | 43,690              | 767                  | (114,198)(d)  | 44,457                |

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|   |                |                |                |                  |                |
|---|----------------|----------------|----------------|------------------|----------------|
| Accrued and other current liabilities                                       | 23,865         | 36,073         |                | (23,865)(d)      | 36,073         |
| Payable to associated companies, net  |                | 6,255          | 1,505          |                  | 7,760          |
| Current maturities of long-term debt  | 30,000         | 38,309         |                | (30,000)(d)      | 38,309         |
|   | <u>168,063</u> | <u>151,027</u> | <u>2,272</u>   | <u>(168,063)</u> | <u>153,299</u> |
| Total current liabilities   | 168,063        | 151,027        | 2,272          | (168,063)        | 153,299        |
| LONG-TERM DEBT, less current maturities                                     | 196,000        | 360,762        |                | 275,000(b)       | 685,762        |
|   |                |                |                | (196,000)(d)     |                |
|   |                |                |                | 50,000(h)        |                |
| MINORITY INTERESTS AND OTHER  | 157            | 4,002          |                | (157)(d)         | 647            |
|   |                |                |                | (3,355)(i)       |                |
| DEFERRED INCOME TAXES   | 55,385         |                | 103,930        |                  | 159,315        |
|   | <u>419,605</u> | <u>515,791</u> | <u>106,202</u> | <u>(42,575)</u>  | <u>999,023</u> |
|   |                |                |                |                  |                |
| PARTNERS' CAPITAL:  |                |                |                |                  |                |
| General partner's capital   |                | 2,190          |                | (110)(e)         | 14,706         |
|   |                |                |                | 4,488(f)         |                |
|   |                |                |                | 3,355(i)         |                |
|   |                |                |                | 15,903(j)        |                |
|   |                |                |                | (9,944)(k)       |                |
|   |                |                |                | (33)(l)          |                |
|   |                |                |                | (1,143)(m)       |                |
| Limited partners' capital, 26,722 issued and outstanding                    | 181,088        | 221,207        |                | (157,609)(a)     | 413,985        |
|   |                |                |                | 292,480(c)       |                |
|   |                |                |                | (4,182)(e)       |                |
|   |                |                |                | 170,636(f)       |                |
|   |                |                |                | (1,012)(j)       |                |
|   |                |                |                | 157,941(k)       |                |
|   |                |                |                | (401,511)(k)     |                |
|   |                |                |                | (1,247)(l)       |                |
|   |                |                |                | (43,457)(m)      |                |
|   |                |                |                | (349)(n)         |                |
| Common stock  |                |                | 5              | (5)(h)           |                |
| Additional paid-in capital  |                |                | 96,446         | (11,539)(g)      |                |
|   |                |                |                | (84,907)(h)      |                |
| Retained earnings   |                |                | (16,973)       | 16,973(h)        |                |
| Class C limited partners capital, 1,000 authorized, issued and outstanding  |                |                |                |                  |                |
| Class D limited partners' capital, 7,722 authorized, issued and outstanding |                |                |                | (1,208)(e)       | 201,620        |
|   |                |                |                | 49,306(f)        |                |
|   |                |                |                | (294)(j)         |                |
|   |                |                |                | 275,968(k)       |                |
|   |                |                |                | (109,234)(k)     |                |
|   |                |                |                | (361)(l)         |                |
|   |                |                |                | (12,557)(m)      |                |
| Treasury units - class E units, 4,427 authorized, issued and outstanding    |                |                |                | (200,386)(h)     | (200,386)      |
| Other comprehensive income (loss)   |                | (349)          | (52)           | 52(h)            |                |
|   |                |                |                | 349(n)           |                |
|   | <u>181,088</u> | <u>223,048</u> | <u>79,426</u>  | <u>(53,637)</u>  | <u>429,925</u> |
| Total partners' capital   | 181,088        | 223,048        | 79,426         | (53,637)         | 429,925        |
| Total liabilities and partners' capital                                     | \$ 600,693     | \$ 738,839     | \$ 185,628     | \$ (96,212)      | \$ 1,428,948   |

See accompanying notes.



Table of ContentsIndex to Financial Statements

## HERITAGE PROPANE PARTNERS, L.P.

## UNAUDITED PRO FORMA COMBINED STATEMENT OF OPERATIONS

Year Ended August 31, 2003

|  | Energy                                  |            | Transfer |                                |              |
|--|---|------------|----------|--------------------------------|--------------|
|  | Pro Forma                               | Heritage   | Heritage | Pro Forma                      | Pro Forma    |
|  | Combined                                | Propane    | Holdings | Adjustments                    | Combined     |
|  | (In thousands, except per unit amounts) |            |          |                                |              |
| REVENUES   | \$ 1,142,964                            | \$ 571,476 | \$       | \$                             | \$ 1,714,440 |
| COSTS AND EXPENSES:                              |   |            |          |                                |              |
| Cost of products sold                            | 1,012,341                               | 297,156    |          |                                | 1,309,497    |
| Operating expenses                               | 22,735                                  | 152,131    | 435      |                                | 175,301      |
| Depreciation and amortization                    | 15,996                                  | 37,959     |          | 1,183(o)<br>1,006(p)<br>101(q) | 56,245       |
| Selling, general and administrative              | 17,842                                  | 14,037     |          | (90)(q)                        | 31,789       |
| Total costs and expenses                         | 1,068,914                               | 501,283    | 435      | 2,200                          | 1,572,832    |
| OPERATING INCOME (LOSS)                          | 74,050                                  | 70,193     | (435)    | (2,200)                        | 141,608      |
| OTHER INCOME (EXPENSE):                          |   |            |          |                                |              |
| Interest expense                                 | (13,770)                                | (35,740)   | (80)     | (4,480)(r)                     | (54,070)     |
| Equity in earnings (losses) of affiliates        | (251)                                   | 1,371      | 8,251    | (8,251)(s)                     | 1,120        |
| Gain on disposal of assets                       |   | 430        |          | (157)(t)                       | 273          |
| Other  | (302)                                   | (3,213)    | 1,295    | (692)(u)                       | (2,912)      |
| INCOME BEFORE MINORITY INTEREST AND INCOME TAXES | 59,727                                  | 33,041     | 9,031    | (15,780)                       | 86,019       |
| MINORITY INTERESTS                               |   | 876        |          | (318)(v)                       | 558          |
| INCOME BEFORE INCOME TAXES                       | 59,727                                  | 32,165     | 9,031    | (15,462)                       | 85,461       |
| INCOME TAXES                                     | 6,015                                   | 1,023      | 3,886    |                                | 10,924       |
| NET INCOME                                       | \$ 53,712                               | \$ 31,142  | \$ 5,145 | \$ (15,462)                    | 74,537       |
| GENERAL PARTNER S INTEREST IN NET INCOME         |   |            |          |                                | 1,491        |
| LIMITED PARTNERS INTEREST IN NET INCOME          |   |            |          |                                | \$ 73,046    |

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|  |         |
|--|---------|
| BASIC AND DILUTED NET INCOME PER LIMITED PARTNER UNIT          | \$ 2.24 |
| BASIC AND DILUTED WEIGHTED AVERAGE NUMBER OF UNITS OUTSTANDING | 32,546  |

See accompanying notes.

F-5

**Table of Contents**

**Index to Financial Statements**

**HERITAGE PROPANE PARTNERS, L.P.**

**NOTES TO UNAUDITED PRO FORMA COMBINED FINANCIAL STATEMENTS**

**(dollars in thousands, except per unit amounts)**

**1. Basis of Presentation and Other Transactions**

The unaudited pro forma combined financial statements do not give any effect to any restructuring cost, potential cost savings, or other operating efficiencies that are expected to result from the Energy Transfer Transaction. The unaudited pro forma combined financial statements are based on certain assumptions and do not purport to be indicative of the results which actually would have been achieved if the Energy Transfer Transaction had been consummated on the dates indicated or which may be achieved in the future. The purchase accounting adjustments made in connection with the development of the unaudited pro forma combined financial statements are preliminary and have been made solely for purposes of presenting such pro forma financial information.

It has been assumed that for purposes of the unaudited pro forma combined balance sheet, the following transactions occurred on August 31, 2003, and for purposes of the unaudited pro forma combined statement of operations, the following transactions occurred on September 1, 2002. The unaudited pro forma combined balance sheet data combines the August 31, 2003 balance sheets of Energy Transfer, Heritage, and Heritage Holdings, after giving effect to pro forma adjustments. The unaudited pro forma combined statement of operations for the year ended August 31, 2003, combines the pro forma results of operations for the year ended August 31, 2003 of Energy Transfer, with the results of operations for the year ended August 31, 2003 of Heritage and Heritage Holdings, after giving effect to pro forma adjustments.

In November 2003, Heritage signed a definitive agreement with La Grange Energy pursuant to which La Grange Energy will contribute its subsidiary Energy Transfer to Heritage in exchange for cash of \$300,000, less the amount of Energy Transfer debt in excess of \$151,500, which will be repaid as part of the transaction, and less Energy Transfer's accounts payable and other specified liabilities plus any agreed upon capital expenditures paid by La Grange Energy relating to the Energy Transfer business prior to closing, and \$433,909 of Common Units and Class D Units of Heritage. For purposes of these unaudited pro forma combined financial statements, agreed upon capital expenditures of \$5,000 have been assumed and the units are valued at \$35.74, the average closing price of Heritage's common units on the New York Stock Exchange for the period three days before and three days after the signing of the definitive agreement on November 6, 2003. In conjunction with the Energy Transfer Transaction, Energy Transfer will distribute its cash and accounts receivables to La Grange Energy and an affiliate of La Grange Energy will contribute an office building to Energy Transfer, in each case prior to the contribution of Energy Transfer to Heritage. La Grange Energy will also receive 3,742,515 Special Units as contingent consideration for completing the Bossier Pipeline. If the Bossier Pipeline does not become commercially operational by December 1, 2004 and, as a result, XTO Energy, Inc. exercises rights to acquire the Bossier Pipeline pursuant to its transportation contract, the Special Units will no longer be considered outstanding and will not be entitled to any rights afforded any other of our units. The Special Units will convert to Common Units upon the Bossier Pipeline becoming commercially operational and such conversion being approved by Heritage's unitholders. In accordance with Statement of Financial Accounting Standards (SFAS) No. 141, the Special Units have not been recorded in the following pro forma balance sheet.

Simultaneously with this acquisition, La Grange Energy will obtain control of Heritage by acquiring all of the interest in U.S. Propane, L.P., the general partner of Heritage, and U.S. Propane, L.L.C., the general partner



**Table of Contents**

**Index to Financial Statements**

of U.S. Propane L.P., from the Utilities for \$30,000. U.S. Propane, L.P. will contribute its 1.0101% general partner interest in Heritage Operating, L.P. ( Heritage Operating ) to Heritage in exchange for an additional 1% general partner interest in Heritage. Heritage will also buy the outstanding stock of Heritage Holdings for \$100,000 funded with \$50,000 of cash and a \$50,000 note payable to the Utilities.

These pro forma combined financial statements assume that concurrent with the Energy Transfer Transaction, Energy Transfer will borrow \$275,000 from financial institutions, and Heritage Propane will raise \$309,520 of gross proceeds through the sale of 8,000,000 Common Units at an offering price of \$38.69 per unit. The total of the proceeds will be used to finance the transaction and for general partnership purposes.

The Energy Transfer Transaction will be accounted for as a reverse acquisition in accordance with SFAS No. 141. Although Heritage is the surviving parent entity for legal purposes, Energy Transfer will be the acquiror for accounting purposes. The assets and liabilities of Heritage Propane will be reflected at fair value to the extent acquired by Energy Transfer, which will be approximately 36.5%, determined in accordance with EITF 90-13. The assets and liabilities of Energy Transfer will be reflected at historical cost. The acquisition of Heritage Holdings by Heritage Propane will be accounted for as a capital transaction as the primary asset held by Heritage Holdings is 4,426,916 Common Units of Heritage Propane. Following the acquisition of Heritage Holdings by Heritage Propane, these Common Units will be converted to Class E Units. The Class E Units will be recorded as treasury units in the unaudited pro forma combined balance sheet.

If the Bossier Pipeline extension contingency described above occurs and the Special Units convert to Common Units, the Common Units will be valued at \$35.74 per unit for total consideration of approximately \$134 million. The Bossier Pipeline will be recorded at its historical cost. The issuance of the additional Common Units upon the conversion of the special units will adjust the percent of Heritage Propane acquired in the Energy Transfer Transaction and will result in an additional step-up being recorded in accordance with EITF 90-13. If the Special Units were converted to Common Units in the pro forma balance sheet, Energy Transfer would have acquired approximately 42.8% of Heritage Propane and recorded approximately \$39 million as an additional step-up in the assets and liabilities of Heritage Propane.

The historical financial statements of Energy Transfer will become the historical financial statements of the registrant. The results of operations of Heritage Propane will be included with the results of Energy Transfer after completion of the Energy Transfer Transaction. Energy Transfer was formed on October 1, 2002 and will have an August 31 year-end. Accordingly, Energy Transfer's 11-month period ended August 31, 2003, will be treated as a transition period under the rules of the Securities and Exchange Commission.

The excess purchase price over predecessor cost was determined as follows:

|  |                  |
|--|------------------|
| Net book value of Heritage Propane at August 31, 2003    | \$ 223,048       |
| Historical goodwill at August 31, 2003                   | (156,595)        |
| Equity investment from public offering                   | 309,520          |
| Treasury class E unit purchase                           | (200,386)        |
|  | <u>175,587</u>   |
| Percent of Heritage Propane acquired by La Grange Energy | 36.5%            |
|  | <u>\$ 64,090</u> |
| Fair market value of limited partner units               | \$ 651,331       |



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|  |                   |
|--|-------------------|
| Purchase price of general partner interest               | 30,000            |
| Equity investment from public offering                   | 309,520           |
| Treasury class E unit purchase                           | (200,386)         |
|  | <u>790,465</u>    |
| Percent of Heritage Propane acquired by La Grange Energy | 36.5%             |
|  | <u>288,520</u>    |
| Fair value of equity acquired                            | 288,520           |
| Net book value of equity acquired                        | 64,090            |
|  | <u>\$ 224,430</u> |

F-7

**Table of Contents**

**Index to Financial Statements**

For purposes of the pro forma balance sheet, the excess of purchase price over predecessor costs have been allocated using the acquisition methodology used by Heritage Propane when evaluating potential acquisitions. Following the consummation of the Energy Transfer Transaction, an appraisal will be obtained to record the final asset valuations. Management of Heritage Propane is in the process of engaging an appraisal firm to perform the asset appraisal, however management does not anticipate that the final valuation will be materially different than the preliminary allocation. The preliminary allocation used in the pro forma balance sheet is as follows:

|  |            |
|--|------------|
| Property, plant and equipment (30 year life) | \$ 35,491  |
| Investment in affiliate                      | 2,302      |
| Customer lists (15 year life)                | 15,096     |
| Trademarks                                   | 10,688     |
| Goodwill                                     | 160,853    |
|  | <hr/>      |
|  | \$ 224,430 |
|  | <hr/>      |

**Table of Contents****Index to Financial Statements**

For purposes of the pro forma statement of operations, pro forma basic and diluted earnings per limited partner unit is calculated as follows:

|  |           |
|--|-----------|
| Basic pro forma net income per limited partner unit:   |           |
| Limited partners' interest in pro forma net income   | \$ 73,046 |
| <hr/>  |           |
| Historical weighted average limited partner units  | 16,636    |
| Conversion of phantom units to common units upon change in control                           | 196       |
| Units issued in this offering  | 8,000     |
| Common units and class D units issued in conjunction with the Energy Transfer Transaction    | 12,141    |
| Common units converted to class E units and recorded as treasury units                       | (4,427)   |
| <hr/>  |           |
| Weighted average limited partner units   | 32,546    |
| <hr/>  |           |
| Basic pro forma net income per limited partner unit  | \$ 2.24   |
| <hr/>  |           |
| Diluted pro forma net income per limited partner unit:                                       |           |
| Limited partners' interest in pro forma net income   | \$ 73,046 |
| <hr/>  |           |
| Historical weighted average limited partner units, assuming dilutive effect of phantom units | 16,694    |
| Less weighted average phantom units outstanding  | (58)      |
| Conversion of phantom units to common units upon change in control                           | 196       |
| Units issued in this offering  | 8,000     |
| Common units and class D units issued in conjunction with the Energy Transfer Transaction    | 12,141    |
| Common units converted to class E units and recorded as treasury units                       | (4,427)   |
| <hr/>  |           |
| Weighted average limited partner units   | 32,546    |
| <hr/>  |           |
| Diluted pro forma net income per limited partner unit  | \$ 2.24   |
| <hr/>  |           |

**2. Pro Forma Adjustments**

- (a) Reflects the distribution of cash and accounts receivable of Energy Transfer to La Grange Energy and the contribution of an office building owned by an affiliate of La Grange Energy to Energy Transfer.
- (b) Reflects borrowing of \$275,000 under the new Energy Transfer credit facility, net of loan origination fees of \$4,000. The borrowing is assumed to have a fixed average interest rate of 5%.
- (c) Reflects the net proceeds received from this offering of 8,000,000 Common Units of Heritage Propane at an offering price of \$38.69 per unit, net of underwriting discount of approximately \$17,040.
- (d) Reflects the repayment of Energy Transfer's existing debt, accounts payable and other specified liabilities of Energy Transfer that were outstanding immediately prior to the Energy Transfer Transaction and the reimbursement of certain capital expenditures.

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- (e) Reflects cash used to pay offering and other transaction costs of \$5,500, allocated to the partners' capital accounts based on their ownership percentages.
- (f) Reflects the allocation of the excess purchase price over predecessor costs to property, plant and equipment of \$35,491, investment in affiliate of \$2,302, customer lists of \$15,096, trademarks of \$10,688 and goodwill of \$160,853, and the allocation to partners' capital based on their ownership percentages.
- (g) Reflects the elimination of a note receivable held by Heritage Holdings that is to be distributed to the Utilities that own U.S. Propane, L.P.

F-9

**Table of Contents**

**Index to Financial Statements**

- (h) Represents cash paid of \$50,000 and the issuance of a \$50,000 7% note payable to the Utilities for all of the common stock of Heritage Holdings and the assumption of liabilities of Heritage Holdings of \$104,697. The purchase price is allocated as follows:

|                                 |                |
|---------------------------------|----------------|
| Cash paid to the Utilities      | \$ 50,000      |
| Note payable to the Utilities   | 50,000         |
| Assumption of liabilities       | 104,697        |
|                                 | <u>204,697</u> |
| Allocated to assets as follows: |                |
| Current assets                  | \$ 4,311       |
| Investment in Heritage Propane  | 200,386        |
|                                 | <u>204,697</u> |

The investment in Heritage Holdings is recorded as Treasury Units in the unaudited pro forma combined balance sheet as Heritage Holdings becomes a wholly-owned subsidiary of Heritage Propane as part of the Energy Transfer Transaction.

- (i) Reflects the contribution of U.S. Propane, L.P.'s 1.0101% general partner interest in Heritage Operating to Heritage Propane for an additional 1% general partner interest in Heritage Propane.
- (j) Reflects the contribution from U.S. Propane, L.P. to Heritage of cash of \$14,597 and an interest in Energy Transfer of \$1,306 in connection with this offering and the Energy Transfer Transaction in order to maintain its 2% general partner interest in Heritage.
- (k) Reflects the payment of cash to La Grange Energy of \$86,780 and the issuance to La Grange Energy of 4,419,177 Common Units, and 7,721,542 Class D Units of Heritage Propane. Also reflects the allocation of such amounts to partners' capital based on their ownership percentages.

|   |                |
|---|----------------|
| Cash paid to La Grange Energy for Energy Transfer       | \$ 86,780      |
| Issuance of 4,419,177 Common Units of Heritage Propane  | 157,941        |
| Issuance of 7,721,542 Class D Units of Heritage Propane | 275,968        |
|   | <u>520,689</u> |

- (l) Reflects the payment of compensation to the executive officers of Heritage Propane under the change of control provisions contained in the executive officers' employment agreements, allocated to partners' capital based on their ownership percentages.
- (m) Reflects elimination of goodwill of Heritage Propane to the extent Heritage Propane was acquired by Energy Transfer, and the allocation of such amount to partners' capital based on their ownership interests.
- (n) Reflects the elimination of accumulated other comprehensive income.

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- (o) Reflects the additional depreciation related to the step-up of net book value of property, plant and equipment having 30-year lives.
- (p) Reflects the additional amortization related to the step-up of net book value of customer lists having lives of 15 years. Trademarks and goodwill are indefinite-lived assets subject to annual tests for impairment.

F-10

**Table of Contents**

**Index to Financial Statements**

(q) Reflects the effect on depreciation of the contribution of the Dallas office building from an affiliate of La Grange Energy to Energy Transfer and the reversal of rent previously paid.

(r) Allocation of additional interest expense of \$13,250 related to the \$275,000 of borrowings under the term loan at an assumed average interest rate of 5%, amortization of loan origination fees of \$1,000 and \$3,500 of additional interest expense related to the issuance of a \$50,000 note payable to the Utilities at an average interest rate of 7%. This additional expense is offset by the elimination of \$13,770 of interest on the repayment of the Energy Transfer debt of \$226,000. A 1/8% change in the interest rate on the \$275,000 of borrowings under the term loan would change interest expense by approximately \$344.

(s) Reflects elimination of Heritage Holding's equity in earnings of Heritage Propane.

(t) Reflects the elimination of the gain on sale of assets as the assets are recorded at fair market value.

(u) Reflects elimination of interest income from the note receivable of \$11,539 which was retained by the Utilities. The note receivable had an interest rate of 6%.

(v) Reflects the elimination of minority interest expense for the 1.0101% general partner's interest in Heritage Operating contributed to Heritage Propane for an additional 1% general partner interest in Heritage Propane.

**Summary of La Grange Transactions and Related Pro Forma Financial Statements**

The following is Energy Transfer's unaudited pro forma combined statement of operations for the year ended August 31, 2003.

The unaudited pro forma combined statement of operations gives pro forma effect to the following transactions as if they had occurred on September 1, 2002.

The October 1, 2002 purchase of the operating assets of Aquila Gas Pipeline Corporation by Energy Transfer.

The December 27, 2002 redemption by Oasis Pipe Line Company of the 50% of its common stock held by Dow Hydrocarbons Resources, Inc., resulting in Energy Transfer's becoming the 100% owner of Oasis Pipe Line Company.

The December 27, 2002 contribution of other assets and a marketing operation by ETC Holdings L.P. to Energy Transfer.

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The Energy Transfer unaudited pro forma amounts are included in the pro forma statements of Heritage Propane, included on pages F-2 through F-10 elsewhere in the prospectus supplement, which reflect the pro forma effects of the combination of Heritage Propane and Energy Transfer and the offering and related transactions as contemplated in this prospectus supplement.

F -11



**Table of Contents**

**Index to Financial Statements**

These transaction adjustments are presented in the notes to the Energy Transfer unaudited pro forma combined statement of operations. The unaudited pro forma combined statement of operations and accompanying notes should be read together with the financial statements and related notes included elsewhere in the prospectus.

The Energy Transfer unaudited pro forma combined statement of operations was derived by adjusting the historical financial statements of Aquila Gas Pipeline, Energy Transfer and Oasis Pipe Line Company. However, management believes that the adjustments provide a reasonable basis for presenting the significant effects of the transactions described above. The unaudited pro forma combined statement of operations does not purport to present the results of operations of Energy Transfer had the transactions above actually been completed as of the dates indicated. Moreover, the unaudited pro forma combined statement of operations does not project the results of operations of Energy Transfer for any future date or period.

Table of ContentsIndex to Financial Statements

## ENERGY TRANSFER COMPANY

## UNAUDITED PRO FORMA COMBINED STATEMENT OF OPERATIONS

For the Year Ended August 31, 2003

|                                   | Energy Transfer                     | Oasis Pipe   |  | ET Company I                        | Adjustments | Pro Forma    |
|-----------------------------------|-------------------------------------|--|--|-------------------------------------|-------------|--------------|
|                                   | Eleven Months Ended August 31, 2003 | Aquila Gas Pipeline One Month Ended September 30, 2002 | Line Four Months Ended December 27, 2002 | Four Months Ended December 27, 2002 |             |              |
| (In thousands)                    |                                     |  |  |                                     |             |              |
| OPERATING REVENUES                | \$ 1,008,723                        | \$ 66,563  | \$ 11,532                                | \$ 57,409                           | (1,263)(a)  | \$ 1,142,964 |
| COSTS AND EXPENSES:               |                                     |  |  |                                     |             |              |
| Cost of sales                     | 899,539                             | 59,691   | 283                                      | 55,003                              | (1,263)(a)  | 1,013,253    |
| Operating                         | 19,081                              | 1,669  | 1,424                                    | 561                                 |             | 22,735       |
| General and administrative        | 15,965                              | 3  | 1,215                                    | 659                                 |             | 17,842       |
| Depreciation and amortization     | 13,461                              | 2,226  | 701                                      |                                     | (1,241)(b)  | 15,996       |
|                                   |                                     |  |  |                                     | 849(c)      |              |
| Unrealized (gain) on derivatives  | (912)                               |  |  |                                     |             | (912)        |
| Total costs and expenses          | 947,134                             | 63,589   | 3,623                                    | 56,223                              | (1,655)     | 1,068,914    |
| INCOME FROM OPERATIONS            | 61,589                              | 2,974  | 7,909                                    | 1,186                               | 392         | 74,050       |
| OTHER INCOME (EXPENSE)            | 102                                 | 4  | (408)                                    |                                     |             | (302)        |
| EQUITY IN NET INCOME OF AFFILIATE | 1,423                               | 850  |  | (94)                                | (2,430)(d)  | (251)        |
| INTEREST AND DEBT EXPENSES, net   | 12,057                              | 393  | (33)                                     |                                     | 1,353(e)    | 13,770       |
| INCOME BEFORE INCOME TAXES        | 51,057                              | 3,435  | 7,534                                    | 1,092                               | (3,391)     | 59,727       |
| INCOME TAX EXPENSE                | 4,432                               | 879  | 2,639                                    |                                     | (1,056)(f)  | 6,015        |
|                                   |                                     |  |  |                                     | (879)(g)    |              |
| NET INCOME                        | \$ 46,625                           | \$ 2,556   | \$ 4,895                                 | \$ 1,092                            | \$ (1,456)  | \$ 53,712    |

**Table of Contents**

**Index to Financial Statements**

**ENERGY TRANSFER COMPANY**

**NOTES TO UNAUDITED PRO FORMA COMBINED STATEMENT OF OPERATIONS**

**1. Basis of Presentation and Other Transactions**

The historical financial information is derived from the historical financial statements of our predecessor company, Aquila Gas Pipeline and subsidiaries ( Aquila Gas Pipeline ) as well as the financial statements of Energy Transfer and Oasis Pipe Line Company ( Oasis ) and ET Company I.

The pro forma statement of operations reflects the closing of the following transactions as if they occurred on September 1, 2002:

The October 1, 2002 purchase of the operating assets of Aquila Gas Pipeline by Energy Transfer.

The December 27, 2002 redemption by Oasis of the 50% of its common stock held by Dow Hydrocarbons Resources, Inc, resulting in Energy Transfer being the 100% owner of Oasis.

The December 27, 2002 contribution of ET Company I, consisting of other assets and a marketing operation, by ETC Holdings, L.P. to Energy Transfer.

The following describes where each of the columns on the unaudited pro forma combined statement of operations was derived:

*Energy Transfer* This column was derived from the audited financial statements of Energy Transfer for the eleven months ended August 31, 2003.

*Aquila Gas Pipeline* Energy Transfer purchased the assets and operations of Aquila Gas Pipeline effective October 1, 2002. After this date, the operations are included in the Energy Transfer financial statements. This column was derived from the unaudited financial statements of Aquila Gas Pipeline for the one-month ended September 30, 2002.

*Oasis Pipe Line* Prior to December 27, 2002, Energy Transfer and its predecessor, Aquila Gas Pipeline, owned 50% of Oasis and accounted for Oasis under the equity method. On December 27, 2002 the remaining 50% of Oasis was purchased. After this date, the results of Oasis's operations are consolidated into the results of Energy Transfer. This column was derived from the unaudited financial statements of Oasis for the

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four months ended December 27, 2002.

*ET Company I* ETC Holdings, L.P. contributed ET Company I to Energy Transfer on December 27, 2002. After this date, ET Company I's results of operations are included in the financial statements of Energy Transfer. This column was derived from the unaudited financial statements of ET Company I for the four month period ended December 27, 2002.

### **2. Pro Forma Adjustments**

- (a) Reflects the elimination of transportation revenue of Oasis for services provided to Energy Transfer and Aquila Gas Pipeline for the four months ended December 27, 2002.

F-14

**Table of Contents**

**Index to Financial Statements**

- (b) Reflects the decrease to depreciation expense resulting from the change in carrying value of the basis in property plant and equipment as a result of the acquisition of Aquila Gas Pipeline's assets.
- (c) Reflects the increase to depreciation expense resulting from the change in carrying value of Oasis's assets as a result of Oasis's redemption of the equity interest held by Dow Hydrocarbons Resources, Inc. and the contribution of other assets and marketing operations to Energy Transfer from ETC Holdings, L.P.
- (d) Reflects the elimination of the equity method income derived from Oasis prior to its becoming a wholly owned subsidiary.
- (e) Reflects the adjustment to interest expense as a result of the assumption of a September 1, 2002 purchase transaction date for the assets of Aquila Gas Pipeline and the redemption of the Oasis equity interests. In addition, this adjustment reflects the change in amortization of the deferred financing costs as though these costs were incurred as of September 1, 2002.
- (f) Reflects the reduction in income tax expense at Oasis as a result of an intercompany note between Energy Transfer and Oasis. The proceeds from the note were used to redeem the equity interest in Oasis held by Dow Hydrocarbons Resources, Inc. It also reflects the tax effects of the change in depreciation expense related to Oasis as described in (c).
- (g) Reflects the elimination of income tax expense of Aquila Gas Pipeline. Aquila was taxed as a C corporation as opposed to Energy Transfer's limited partnership structure.

Table of Contents

Index to Financial Statements

**REPORT OF INDEPENDENT AUDITORS**

To the Partners of  
Energy Transfer Company

We have audited the accompanying combined balance sheet of Energy Transfer Company as of August 31, 2003, and the related combined statements of income, partners' capital, and cash flows for the eleven month period ended August 31, 2003. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of Energy Transfer Company as of August 31, 2003, and the combined results of their operations and their cash flows for the eleven month period ended August 31, 2003 in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

San Antonio, Texas

December 5, 2003

F-16

**Table of Contents****Index to Financial Statements****ENERGY TRANSFER COMPANY****COMBINED BALANCE SHEETS**

|  | <b>August 31,</b>     |
|--|-----------------------|
|  | <b>2003</b>           |
|  | <b>(In Thousands)</b> |
| <b>ASSETS</b>                                |                       |
| <b>CURRENT ASSETS:</b>                       |                       |
| Cash and cash equivalents                    | \$ 53,122             |
| Accounts receivable                          | 105,987               |
| Deposits paid to vendors                     | 19,053                |
| Materials and supplies                       | 2,071                 |
| Inventories and exchanges, net               | 1,839                 |
| Price risk management asset                  | 928                   |
| Other current assets                         | 770                   |
|  | <hr/>                 |
| Total current assets                         | 183,770               |
| Equity method investments                    | 6,844                 |
| Property, plant and equipment                | 406,697               |
| Less Accumulated depreciation                | (13,672)              |
|  | <hr/>                 |
| Property, Plant and equipment, net           | 393,025               |
| Goodwill                                     | 13,409                |
| Intangibles (net of \$2,556 in amortization) | 3,645                 |
|  | <hr/>                 |
| Total assets                                 | \$ 600,693            |
| <b>LIABILITIES AND PARTNERS CAPITAL</b>      |                       |
| <b>CURRENT LIABILITIES:</b>                  |                       |
| Accounts payable                             | \$ 114,198            |
| Accounts payable to related parties          | 820                   |
| Current maturities of long-term debt         | 30,000                |
| Deposits from customers                      | 11,600                |
| Accrued expenses                             | 7,041                 |
| Price risk management liabilities            | 823                   |
| Income taxes payable                         | 2,567                 |
| Accrued interest                             | 1,014                 |
|  | <hr/>                 |
| Total current liabilities                    | 168,063               |
| Long term debt                               | 196,000               |
| Deferred income taxes                        | 55,385                |
| Other non-current liabilities                | 157                   |
| Commitments and contingencies                |                       |
| Partners capital                             | 181,088               |

|   |                   |
|---|-------------------|
| Total liabilities and partners' capital | <u>\$ 600,693</u> |
|---|-------------------|

See accompanying notes.

F-17



Table of ContentsIndex to Financial Statements

## ENERGY TRANSFER COMPANY

## COMBINED INCOME STATEMENTS

|                                   | Eleven Months Ended |
|-----------------------------------|---------------------|
|                                   | August 31, 2003     |
|                                   | (In Thousands)      |
| OPERATING REVENUES                |                     |
| Third Party                       | \$ 1,008,014        |
| Affiliated                        | 709                 |
|                                   | <u>\$ 1,008,723</u> |
| COSTS AND EXPENSES:               |                     |
| Cost of sales                     | 899,539             |
| Operating                         | 19,081              |
| General and administrative        | 15,965              |
| Depreciation and amortization     | 13,461              |
| Unrealized (gain) on derivatives  | (912)               |
|                                   | <u>947,134</u>      |
| INCOME FROM OPERATIONS            | 61,589              |
| OTHER INCOME                      | 102                 |
| EQUITY IN NET INCOME OF AFFILIATE | 1,423               |
| INTEREST AND DEBT EXPENSES, net   | (12,057)            |
|                                   | <u>51,057</u>       |
| INCOME BEFORE INCOME TAXES        | 51,057              |
| INCOME TAX EXPENSE                | (4,432)             |
|                                   | <u>\$ 46,625</u>    |

See accompanying notes.

Table of ContentsIndex to Financial Statements

## ENERGY TRANSFER COMPANY

## COMBINED STATEMENT OF PARTNERS' CAPITAL

For the Eleven Months Ended August 31, 2003

|                                   | LaGrange Acquisition, LP |           | Operating    | Total      |
|-----------------------------------|--------------------------|-----------|--------------|------------|
|                                   | Limited                  | General   | Partnerships |            |
|                                   | Partner s                | Partner s | Partner s    | Partners   |
|                                   | Capital                  | Capital   | Capital      | Capital    |
|                                   | (In Thousands)           |           |              |            |
| Capital contribution              | \$ 108,163               | \$ 108    | \$           | \$ 108,271 |
| ET Company 1 capital contribution | 31,017                   |           |              | \$ 31,017  |
| Distribution to partners          | (4,815)                  | (5)       | (5)          | (4,825)    |
| Net income                        | 46,531                   | 47        | 47           | 46,625     |
| Balance August 31, 2003           | \$ 180,896               | \$ 150    | \$ 42        | \$ 181,088 |

See accompanying notes.

**Table of Contents****Index to Financial Statements****ENERGY TRANSFER COMPANY****COMBINED STATEMENTS OF CASH FLOWS****(In Thousands)**

|   | <b>Eleven Months Ended</b> |
|---|----------------------------|
|   | <b>August 31, 2003</b>     |
|   | <b>_____</b>               |
| <b>Operating Activities</b>   |                            |
| Net income  | \$ 46,625                  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                            |
| Depreciation and amortization, including interest                                 | 15,772                     |
| Deferred income taxes   | (1,116)                    |
| Dividend from Oasis   | 1,000                      |
| Equity method income  | (1,423)                    |
| Other, net  | (40)                       |
| Changes in operating assets and liabilities                                       |                            |
| Accounts receivable   | (83,964)                   |
| Deposits to customers   | (16,962)                   |
| Materials and supplies  | 526                        |
| Inventories and exchanges   | (627)                      |
| Price risk management liabilities, net  | (105)                      |
| Other current assets  | (1,809)                    |
| Accounts payable  | 93,761                     |
| Accounts payable related party  | 820                        |
| Accrued expenses  | 3,202                      |
| Deposits from customers   | 11,600                     |
| Other long-term liabilities   | 157                        |
| Income taxes payable  | 2,567                      |
| Accrued interest  | 932                        |
|   | <b>_____</b>               |
| Net cash provided by operating activities   | 70,916                     |
| <b>Investing Activities</b>   |                            |
| Business acquisition  | (337,148)                  |
| Additions to property, plant and equipment  | (13,872)                   |
| Proceeds from sale of assets  | 9,843                      |
|   | <b>_____</b>               |
| Net cash used in investing activities   | (341,177)                  |
| <b>Financing Activities</b>   |                            |
| Capital contribution  | 108,723                    |
| Distributions to partners   | (4,825)                    |
| Borrowings under credit facility  | 246,000                    |
| Principal payments under credit facility  | (20,000)                   |
| Deferred financing fees   | (6,515)                    |
|   | <b>_____</b>               |
| Net cash provided in financing activities   | 323,383                    |

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|  |           |
|--|-----------|
| Net increase in cash and cash equivalents      | 53,122    |
| Cash and cash equivalents, beginning of period |           |
| Cash and cash equivalents, end of period       | \$ 53,122 |

See accompanying notes.

F-20

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**Table of Contents**

**Index to Financial Statements**

**ENERGY TRANSFER COMPANY**

**NOTES TO COMBINED FINANCIAL STATEMENTS**

**Eleven Months Ended August 31, 2003**

**1. Summary of Business, Basis of Presentation, and Significant Accounting Policies**

***Organization and Business***

Energy Transfer Company is a group of partnerships under common control and consists of La Grange Acquisition, L.P. (La Grange Acquisition) and a series of its limited partner investees. La Grange Acquisition, L.P. is a Texas limited partnership formed on October 1, 2002 and is 99.9% owned by its limited partner, La Grange Energy, L.P. (La Grange Energy), and 0.1% owned by its general partner, LA GP, LLC. La Grange Acquisition is the 99.9% limited partner of ETC Gas Company, Ltd., ETC Texas Pipeline, Ltd., ETC Processing, Ltd., and ETC Marketing, Ltd. and a 99% limited partner of ETC Oasis Pipe Line, L.P. and ET Company I, Ltd. (collectively, the Operating Partnerships). The general partners of La Grange Acquisition, La Grange Energy, and the Operating Partnerships are ultimately owned and controlled by members of management and a private equity investor group. La Grange Acquisition and the Operating Partnerships conduct business under the name Energy Transfer Company. These financial statements present the accounts of La Grange Acquisition and the Operating Partnerships (collectively, the Partnership or Energy Transfer) on a combined basis as entities under common control.

Under state law and the terms of various partnership agreements, the limited partners' potential liability is limited to their investment in the various partnerships. The general partners of the various partnerships manage and control the business and affairs of each partnership. The limited partners are not involved in the management and control of the Partnership. Since all of the general partners in the various partnerships are ultimately owned and controlled by members of management and a private equity investor group, all of the entities that form Energy Transfer, as defined above, are managed and are under the common control of this control group.

In October 2002, La Grange Acquisition acquired the Texas and Oklahoma natural gas gathering and gas processing assets of Aquila Gas Pipeline Corporation (Aquila Gas Pipeline), a subsidiary of Aquila, Inc. for \$264 million, including 50% of the capital stock of Oasis Pipe Line Company, a Delaware Corporation, (Oasis Pipe Line), 20% ownership interest in the Nustar Joint Venture, and an interest in another immaterial venture. On December 27, 2002, Oasis Pipe Line redeemed the remaining 50% of its capital stock owned by Dow Hydrocarbons Resources, Inc. for \$87 million, and cancelled the stock. Thus, Energy Transfer now owns 100% of the outstanding capital stock of Oasis Pipe Line. La Grange Acquisition contributed the assets acquired from Aquila, Inc. to the Operating Partnerships in return for its limited partner interests in the Operating Partnerships.

The Partnership owns and operates natural gas gathering, natural gas intrastate pipeline systems, and gas processing plants and is in the business of purchasing, gathering, compressing, transporting, processing, and marketing natural gas and natural gas liquids (NGLs) in the states of Texas, Oklahoma, and Louisiana.

*Combination*

The accompanying combined financial statements include the accounts of La Grange Acquisition and the Operating Partnerships after the elimination of significant intercompany balances and transactions. Further, La

F-21

**Table of Contents**

**Index to Financial Statements**

Grange Acquisition's limited partner investments in each of the Operating Partnerships have been eliminated against the Operating Partnerships limited partners' capital.

*Use of Estimates*

The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The more significant areas requiring the use of estimates relate to the fair value of financial instruments and useful lives for depreciation. Actual results may differ from those estimates.

**Table of Contents**

**Index to Financial Statements**

***Cash and Cash Equivalents***

All highly liquid investments with an original maturity of three months or less are considered to be cash equivalents. The Partnership's carrying amounts for cash and cash equivalents, other current assets and other current liabilities approximate fair value.

***Accounts Receivable***

Energy Transfer deals with counter parties that are typically either investment grade (Standard & Poors BBB or higher) or are otherwise secured with a letter of credit or other form of security (corporate guaranty or prepayment). The credit committee reviews accounts receivable balances each week. Credit limits are assigned and monitored for all counter parties. The majority of payments are due on the 25th of the month following delivery.

Management closely monitors credit exposure for potential doubtful accounts. Management believes that an occurrence of bad debt is unlikely; therefore an allowance for doubtful accounts is not included on the balance sheet. Bad debt expense is recognized at the time the bad debt occurs. An accounts receivable will be written off when the counter party files for bankruptcy protection or the account is turned over for collection and the collector deems the account uncollectible. We did not record any bad debt expense during the 11 months ended August 31, 2003.

***Deposits***

Deposits are paid to vendors as pre-payments for gas deliveries in the following month. Pre-payments are required when the volume of business with the vendor exceeds the Partnership's credit limit. Deposits with vendors for gas purchases are \$17.0 million at August 31, 2003. The Partnership also has deposits with derivative counterparties at August 31, 2003 of \$2.1 million.

Deposits are received from customers as pre-payments for gas deliveries in the following month. Pre-payments are required when customers exceed their credit limit or do not qualify for open credit. Deposits received from customers for gas sales are \$11.6 million at August 31, 2003.

***Materials and Supplies***

Materials and supplies are stated at the lower of cost (determined on a first-in, first-out basis) or market value.

***Inventories and Exchanges***



Inventories and exchanges consist of NGLs on hand or natural gas and NGL delivery imbalances with others and are presented net by customer/supplier on the accompanying combined balance sheet. These amounts turn over monthly and management believes the cost approximates market value. Accordingly, these volumes are valued at market prices on the combined balance sheet.

F-23

**Table of Contents**

**Index to Financial Statements**

***Price Risk Management Assets and Liabilities***

The Partnership follows FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (Statement No. 133) as amended by FASB Statement No. 138, *Accounting for Certain Derivative Activities and Certain Hedging Activities* (Statement No. 138). These statements establish accounting and reporting standards for derivative instruments and hedging activities. They require that every derivative instrument (including certain derivative instrument embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair market value. The statements require that changes in the derivative's fair value be recognized currently in earnings unless specific hedge criteria are met.

Special accounting for qualifying hedges allows a derivative's gain and loss to offset related results on the hedged item in the income statement and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting. Energy Transfer believes that some of its derivative contracts could qualify as hedges under Statement No. 133; however, at August 31, 2003 no positions have been formally designated as hedges.

Energy Transfer utilizes various exchange-traded and over-the-counter commodity financial instrument contracts to limit its exposure to margin fluctuations in natural gas and NGLs prices. These contracts consist primarily of futures and swaps. The net gain or loss arising from marking to market those derivative instruments is currently recognized in earnings. In the course of normal operations, Energy Transfer also routinely enters into forward physical contracts for the purchase and sale of natural gas and NGLs along various points of its system. These positions require physical delivery and are treated as normal purchase and sales contracts under Statement No. 133. Accordingly, these contracts are not marked to market on the accompanying combined balance sheets. Unrealized gains and losses on commodity derivatives are classified as such on the combined statement of income. Realized gains and losses on commodity derivatives are included in operating revenues, while realized and unrealized gains and losses on interest rate swaps are included in interest expense.

The market prices used to value the financial derivative transactions reflect management's estimates considering various factors including closing exchange and over-the-counter quotations, and the time value of the underlying commitments. The values are adjusted to reflect the potential impact of liquidating a position in an orderly manner over a reasonable period of time under present market conditions.

***Deferred Financing Fees***

Deferred financing fees, included in other assets, are amortized using the effective interest method.

***Investments***

From October through December 2002, the Partnership owned a 20% interest in the Nustar Joint Venture. Effective December 27, 2002, the Partnership owned a 50% interest in Vantex Gas Pipeline Company, LLC, and a 49% interest in Vantex Energy Services, Ltd. The Partnership also owns an interest in an immaterial venture. The Partnership accounts for these investments under the equity method of accounting. The Nustar Joint Venture, located in West Texas, is composed of approximately 290 miles of pipeline and the Benedum processing facility. The Vantex system is located in East Texas and is composed of approximately 250 miles of pipeline. Vantex Energy Services provides energy

related marketing services to small and medium sized producers and end users on the Vantex Gas Pipeline system.

**Table of Contents**

**Index to Financial Statements**

Prior to December 27, 2002, when the remaining 50% of Oasis Pipe Line capital stock was redeemed, the Partnership accounted for its initial 50% ownership in Oasis Pipe Line under the equity method. During the three month period ended December 31, 2002, the Partnership recognized \$1.6 million of equity method income from the investment in Oasis Pipe Line prior to the redemption of the remaining 50% of the capital stock. Oasis results from operations are recognized on a consolidated basis effective January 1, 2003.

Effective January 1, 2003, Energy Transfer sold its interest in the Nustar Joint Venture for \$9.6 million. No gain or loss was recognized, as the proceeds equaled the value assigned to the joint venture in the October 2002 purchase allocation.

***Property, Plant, and Equipment***

Pipeline, property, plant, and equipment are stated at cost. Additions and improvements that add to the productive capacity or extend the useful life of the asset are capitalized. Expenditures for maintenance and repairs that do not add capacity or extend the useful life are charged to expense as incurred. Upon disposition or retirement of pipeline components or gas plant components, any gain or loss is recorded to accumulated depreciation. When entire pipeline systems, gas plants or other property and equipment are retired or sold, any gain or loss is included in operations.

Depreciation of the gathering pipeline systems, gas plants, and processing equipment is provided using the straight-line method based on an estimated useful life of primarily 20 years. The transportation pipeline is depreciated using the straight-line method based on an estimated useful life of primarily 65 years. There was no interest cost capitalized for the period ended August 31, 2003.

Energy Transfer reviews its tangible and finite life intangible assets for impairment whenever facts and circumstances indicate impairment may be present. When impairment indicators are present, the Partnership evaluates whether the assets in question are able to generate sufficient cash flows to recover their carrying value on an undiscounted basis. If not, the Partnership impairs the assets to their fair value, which may be determined based on discounted cash flows. To date no impairments have been recognized.

***Goodwill***

The goodwill represents the fair value of the partnership interests granted to ETC Holdings, L.P. on the contribution of ET Company I in excess of the fair value of the tangible assets contributed. ET Company I included a gas marketing operation, which has no significant assets other than an assembled workforce and marketing expertise. The goodwill is principally the value assigned to the marketing operation of ET Company I. The goodwill is included in our Midstream segment and will be reviewed annually for impairment.

***Federal and State Income Taxes***

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La Grange Acquisition and the Operating Partnerships are organized under the provisions of the Texas Revised Limited Partnership Act. Therefore, the payment and recognition of income taxes are the responsibility of the partners, except as noted below.

Energy Transfer owns Oasis Pipe Line, a corporation and tax-paying entity, which provides for income taxes currently payable and for deferred income taxes in accordance with Financial Accounting Standards Board

F-25

**Table of Contents****Index to Financial Statements**

(FASB) Statement No. 109, *Accounting for Income Taxes* (Statement No. 109). Statement No. 109 requires that deferred tax assets and liabilities be established for the basis differences between the reported amounts of assets and liabilities for financial reporting purposes and income tax purposes.

***Cash Paid for Interest and Income Taxes***

The following provides information related to cash paid for interest and income taxes by the Partnership for the eleven months ended August 31, 2003.

|              | <u>(In thousands)</u> |
|--------------|-----------------------|
| Interest     | \$ 8,486              |
| Income Taxes | \$ 2,935              |

***Revenue Recognition***

We recognize revenue for sales of natural gas and NGLs upon delivery. Service revenues, including transportation, treating, compression, and gas processing, are recognized at the time service is performed. Transportation capacity payments are recognized when earned in the period the capacity was made available.

***Shipping and Handling Costs***

In accordance with the Emerging Issues Task Force Issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Partnership has classified all deductions from producer payments for fuel, compression and treating, which can be considered handling costs, as revenue. The fuel costs are included in costs of sales, while the remaining costs are included in operating costs.

**2. Acquisitions and Sales**

As previously discussed, on October 1, 2002, La Grange Acquisition purchased certain operating assets from Aquila Gas Pipeline, primarily natural gas gathering, treating and processing assets in Texas and Oklahoma. The assets acquired and preliminary purchase price allocation were as follows:

(In thousands)

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|  |            |
|--|------------|
| Materials and supplies                 | \$ 2,596   |
| Other assets                           | 179        |
| Property, plant, and equipment         | 211,783    |
| Investment in Oasis                    | 41,670     |
| Investment in the Nustar Joint Venture | 9,600      |
| Accrued expenses                       | (1,753)    |
|  | <hr/>      |
|  | \$ 264,075 |
|  | <hr/>      |

At the closing of the acquisition of Aquila Gas Pipeline's assets, \$5 million was put into escrow until such time that proper consents and conveyance could be achieved related to a sales contract. It was later determined that it was unlikely that a proper conveyance could be achieved which resulted in the escrowed amount of \$5 million being returned to La Grange Acquisition during the eight months ended August 31, 2003. The return of the \$5 million purchase price reduced La Grange Acquisition's basis in property, plant and equipment.

**Table of Contents****Index to Financial Statements**

On December 27, 2002, Oasis Pipe Line purchased the remaining 50% of its capital stock owned by Dow Hydrocarbons resources, Inc. for \$87 million, and cancelled the stock. Energy Transfer now owns 100% of the capital stock of Oasis Pipe Line.

Also, on December 27, 2002, ETC Holdings, LP, a limited partner of La Grange Energy, contributed ET Company I to the Partnership. The investment in the Vantex system was included in the assets contributed.

The following unaudited pro forma financial information for the period ended August 31, 2003 assumes that both Oasis Pipe Line and ET Company I were wholly owned as of October 1, 2002 (Inception).

|  | <u>(In thousands)</u> |
|--|-----------------------|
| <b>Pro Forma Financial Information</b> |                       |
| Operating Revenues                     | \$ 1,063,729          |
| Total Costs and Expenses               | \$ 983,128            |
| Income from Operations                 | \$ 69,314             |
| Net income                             | \$ 48,739             |

**3. Property, Plant, and Equipment**

Property, plant, and equipment, at cost, consisted of the following:

|   | <u>Estimated Useful</u> | <u>Balance at</u>      |
|---|-------------------------|------------------------|
|   | <u>Lives (Years)</u>    | <u>August 31, 2003</u> |
|   | <u>(In thousands)</u>   |                        |
| Land                                      | N/A                     | \$ 992                 |
| Midstream buildings                       | 15                      | 798                    |
| Midstream pipelines and equipment         | 20                      | 215,099                |
| Midstream right of way                    | 20                      | 336                    |
| Transportation pipeline                   | 65                      | 126,526                |
| Transportation right of way               | 65                      | 3,721                  |
| Transportation buildings                  | 20                      | 189                    |
| Transportation equipment                  | 10-20                   | 42,771                 |
| Linepack                                  | N/A                     | 5,176                  |
| Construction in progress                  | N/A                     | 7,414                  |
| Other                                     | 5                       | 3,675                  |
|   |                         | <hr/>                  |
| Total                                     |                         | 406,697                |
| Accumulated depreciation and amortization |                         | (13,672)               |
|   |                         | <hr/>                  |
| Property, plant and equipment, net        |                         | \$ 393,025             |



**4. Intangible Assets**

As of August 31, 2003, intangibles, at cost, consisted of the following:

|                         | <u>(In thousands)</u> |
|-------------------------|-----------------------|
| Deferred financing fees | \$ 5,724              |
| Amortization            | (2,464)               |
|                         | <u>3,260</u>          |
| Other intangibles       | 477                   |
| Amortization            | (92)                  |
|                         | <u>385</u>            |
| Total intangibles       | <u>\$ 3,645</u>       |

**Table of Contents****Index to Financial Statements**

Deferred financing fees relate to the Term Note (See Note 7 Debt) and are being amortized over the life of the note using the interest rate method.

Other intangibles include a land use lease, which is being amortized over the life of the lease.

The following is the scheduled amortization of intangibles for the next five years:

|            | <u>(In thousands)</u> |
|------------|-----------------------|
| 2004       | \$ 2,404              |
| 2005       | \$ 918                |
| 2006       | \$ 82                 |
| 2007       | \$ 48                 |
| 2008       | \$ 48                 |
| Thereafter | \$ 145                |

**5. Investments*****Nustar Joint Venture***

At December 31, 2002, the Partnership owned a 20% interest in the Nustar Joint Venture, which was accounted for under the equity method. The Nustar Joint Venture, located in West Texas, was composed of approximately 290 miles of pipeline and the Benedum processing facility. In January 2003, the Partnership sold its 20% interest for \$9.6 million resulting in no gain or loss.

***Vantex***

At August 31, 2003, ET Company I owned a 50% interest in Vantex Gas Pipeline Company and a 49% interest in Vantex Energy Services, Ltd., with both interests accounted for under the equity method. The Partnership's equity investment value in the Vantex System at August 31, 2003 was \$7.2 million. The Vantex System interests were owned ET Company I and were contributed to the Partnership on December 27, 2002 by ETC Holdings, LP. The \$7.2 million investment at August 31, 2003 exceeds ET Company I's historical underlying equity in the Vantex System by \$336,000.

The following presents financial information related to the Vantex investments for the 11 months ended August 31, 2003.

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(In thousands)

| <b>Statement of Income Information</b>   |           |
|--|-----------|
| Revenues                                 | \$ 13,116 |
| Income before income tax expense         | \$ 333    |
| The Partnership's share of net income    | \$ 165    |
| The Partnership's share of distributions |           |

Total earnings from equity method investments for the 11 months ended August 31, 2003, excluding Oasis Pipe Line, was a loss of \$149,000. This includes the Partnership's share of net income from Vantex of \$165,000

F-28

**Table of Contents****Index to Financial Statements**

and the Partnership's share of equity method loss of \$314,000 from its other joint venture investments, including a loss from the Nustar Joint Venture prior to its sales.

**6. Related-Party Transactions**

Beginning in 2003 and after the contribution of ET Company I to Energy Transfer, the Partnership is charged rent by an affiliate for office space in Dallas, which is shared with La Grange Energy and ETC Holdings, L.P. For the 11 months ended August 31, 2003, the rent charged to the Partnership was \$90,000.

Prior to the Oasis Pipe Line stock redemption and the contribution of ET Company I, Energy Transfer had purchases and sales of natural gas with Oasis Pipe Line and ET Company I in the normal course of business. The following table summarizes these transactions:

|  | <b>October 1, 2002<br/>(Inception) Through<br/>December 31, 2002</b> |
|--|--|
|  | <b>(In thousands)</b>  |
| Sales of natural gas to affiliated companies       | \$ 4,488   |
| Purchases of natural gas from affiliated companies | \$ 3,989   |
| Transportation expenses                            | \$ 922   |

During 2003, ETC Texas Pipeline, Ltd, one of the Operating Partnerships, purchased a compressor, initially ordered by Energy Transfer Group, L.L.C. (ETG) for \$799,000. ETG is a 66% owned subsidiary of ETC Holdings, L.P. ETG has a contract to provide compression services to a third party for a fixed monthly fee. Proceeds from the contract will be remitted by ETG to ETC Texas Pipeline, Ltd. to provide a 14.6% return on investment for the capital investment made by ETC Texas Pipeline, Ltd. As of August 31, 2003, no fees had been remitted, but income of \$7,000 has been accrued under the contract. In addition, a \$200,000 deposit was made to a third party vendor by ETC Texas Pipeline, Ltd. on behalf of ETG.

Energy Transfer also provides payroll services to ETG. As of August 31, 2003, the receivable due from ETG for payroll services was \$146,141.

Energy Transfer has advanced working capital of \$303,000 to a joint venture partially owned by Energy Transfer, affiliates of ETC Holdings, L.P. and others.

ET GP, LLC, the general partner of ETC Holdings, L.P., has a general and administrative services contract to act as an advisor and provide certain general and administrative services to La Grange Energy and its affiliates, including Energy Transfer. The general and administrative services that ET GP, LLC provides La Grange Energy and its subsidiaries under this contract include:

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General oversight and direction of engineering, accounting, legal and other professional and operational services required for the support, maintenance and operation of the assets used in the Midstream operations; and

The administration, maintenance and compliance with contractual and regulatory requirements.

In exchange for these services, La Grange Energy and its affiliates are required to pay ET GP, LLC a \$500,000 annual fee payable quarterly and pro-rated for any portion of a calendar year. Pursuant to this contract, La Grange Energy and its affiliates were also required to reimburse ET GP, LLC for expenses

F-29

**Table of Contents**

**Index to Financial Statements**

associated with formation of La Grange Energy and its affiliates and are required to indemnify ET GP, LLC, its affiliates, officers and employees for liabilities associated with the actions of ET GP, LLC, its affiliates, officers, and employees. As a result of the reimbursement provision, La Grange Energy charged Energy Transfer \$449,000 for expenses associated with its formation. For the 11 months ended August 31, 2003, Energy Transfer was charged \$375,000 under this contract.

**7. Debt**

Long-term debt consisted of the following as of August 31, 2003:

|                             | August 31,<br>2003 |
|-----------------------------|--------------------|
|                             | (In thousands)     |
| Term notes                  | \$ 226,000         |
| Revolving credit facility   |                    |
| <b>Total debt</b>           | <b>226,000</b>     |
| Less current portion        | 30,000             |
| <b>Total long-term debt</b> | <b>\$ 196,000</b>  |

The scheduled maturities of long-term debt are as follows:

|                     | August 31,<br>2003 |
|---------------------|--------------------|
|                     | (In thousands)     |
| 2004                | \$ 30,000          |
| 2005                | 196,000            |
| 2006 and thereafter |                    |
| <b>Total</b>        | <b>\$ 226,000</b>  |

***Term Note Facility***

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La Grange Acquisition entered into a term note agreement (the Term Note) with a financial institution in the amount of \$246 million. The Term Note is secured by substantially all of the Partnership's assets and bears interest at a LIBOR based rate, which was 4.69% at August 31, 2003. Principal payments of \$7.5 million are due quarterly until final maturity in September 2005, when the remaining outstanding principal balance is due. Upon issuance of the Term Note, the Partnership deferred approximately \$5.7 million of initial fees and expenses and is amortizing such deferred costs over the life of the note.

In January 2003, February 2003, and June 2003, the Partnership paid \$5 million, \$7.5 million, and \$7.5 million, respectively, on the outstanding Term Note balance.

The Term Note requires the Partnership to comply with certain financial covenants as well as limits the activities of the Partnership in other ways. At August 31, 2003, the Partnership was in compliance with such covenants.

### ***Revolving Credit Facility***

The Partnership has a \$40 million revolving credit facility with a financial institution that expires September 30, 2005. The revolving credit facility includes a variable rate line of credit facility and a letter of credit facility.

**Table of Contents****Index to Financial Statements**

Amounts borrowed under the credit facility bear interest at a rate based on either a Eurodollar base rate for Eurodollar Loans, or a base rate currently designated as a LIBOR base rate at the option of the Administrative Agent for Base Rate Loans. The revolving credit facility requires the payment of commitment fees of 1/2 of 1 percent and is secured by substantially all of the Partnership's assets. Letters of credit reduce the amount available under the credit facility.

At August 31, 2003, there were \$565,000 of letters of credit outstanding and no amounts outstanding under the revolving credit facility.

The carrying value of the Partnership's debt obligations approximates their fair value. This determination is based on management's estimate of the fair value at which such instruments could be obtained in an unrelated third-party transaction.

**8. Income Taxes**

As previously disclosed, other than taxes resulting from income of Oasis Pipe Line, income taxes are the responsibility of the partners. The following reconciles net income to the taxable income to be reported directly to the partners for the period ended August 31, 2003:

|                                     | <u>(In thousands)</u> |
|-------------------------------------|-----------------------|
| Income before tax                   | \$ 51,057             |
| Reconciling items:                  |                       |
| Oasis Pipe Line taxed separately    | (12,638)              |
| Depreciation                        | (35,143)              |
| Other                               | 790                   |
|                                     | <u>          </u>     |
| Taxable income reported to partners | <u>\$ 4,066</u>       |

Components of Oasis Pipe Line's income tax provision/(benefit) attributable to income before taxes, as of August 31, 2003, are as follows:

|                          | <u>(In thousands)</u> |
|--------------------------|-----------------------|
| Current                  | \$ 5,548              |
| Deferred                 | (1,116)               |
|                          | <u>          </u>     |
| Total income tax expense | <u>\$ 4,432</u>       |

Deferred tax liabilities of Oasis Pipe Line, as of August 31, 2003, consist of the following:



|                               | <b>(In thousands)</b> |
|-------------------------------|-----------------------|
| Property, plant and equipment | \$ 55,736             |
| Other                         | (351)                 |
| Net deferred tax liabilities  | <u>\$ 55,385</u>      |

### 9. Major Customers

The Partnership had gross sales as a percentage of total revenues to nonaffiliated major customers as follows:

|            | <b>Eleven Months<br/>Ended<br/>August 31, 2003</b> | <b>S&amp;P<br/>Rating</b> |
|------------|--|---------------------------|
| Customer A | 18.85%   | A                         |
| Customer B | 11.26%   | BBB                       |

**Table of Contents****Index to Financial Statements**

The Partnership's natural gas operations have a concentration of customers in natural gas transmission, distribution, and marketing, as well as industrial end-users while its NGL operations have a concentration of customers in the refining and petrochemical industries. These concentrations of customers may impact the Partnership's overall exposure to credit risk, either positively or negatively. However, management believes that the Partnership's portfolio of accounts receivable is sufficiently diversified to minimize any potential credit risk. Historically, the Partnership has not incurred losses in collecting its accounts receivable and, as such, no allowance for doubtful accounts has been provided in the accompanying combined financial statements.

**10. Retirement and Benefit Plans**

Energy Transfer has a defined contribution plan for virtually all employees. Pursuant to the plan, employees of the Partnership can defer a portion of their compensation and contribute it to a deferred account. The Partnership did not elect to match contributions to this plan through August 31, 2003.

**11. Commitments and Contingencies*****Lease Obligations***

The Partnership has operating leases for office space and compressors under noncancelable agreements. The following are the future annual minimum lease payments for each of the next five years as of August 31, 2003:

|            | <b>(In thousands)</b> |
|------------|-----------------------|
| 2004       | \$ 920                |
| 2005       | \$ 927                |
| 2006       | \$ 390                |
| 2007       | \$ 6                  |
| 2008       | \$ 1                  |
| thereafter | \$                    |

Rental expense for the 11 months ended August 31, 2003 relating to operating leases was \$662,000.

***Physical Forward Commodity Commitments***

The Partnership has forward commodity contracts, which will be settled by physical delivery. Short-term contracts, which expire in less than one year, require delivery up to 54 million British thermal units per pay (MMBtu/d). Long-term contracts require delivery of up to 156 MMBtu/d. The long-term contracts run through July 2013.

***Bossier Pipeline Extension***

XTO has signed a long-term agreement to deliver 200 million cubic feet per day (MMcfd) natural gas volumes into a new pipeline system, which is currently under construction. The pipeline will connect East Texas production into the Katy hub near Houston. The term of the XTO agreements runs nine years, through July 2012. The Bossier Pipeline Extension is scheduled to be operational by mid-2004.

Energy Transfer in the normal course of business, purchases, processes and sells natural gas pursuant to long-term contracts. Such contracts contain terms that are customary in the industry.

F-32

**Table of Contents**

**Index to Financial Statements**

The Partnership believes that such terms are commercially reasonable and will not have a material adverse effect on the Partnership's financial position or results of operations.

***Litigation***

On June 16, 2003, Guadalupe Power Partners, L.P. (GPP) sought and obtained a Temporary Restraining Order against Oasis Pipe Line. In their pleadings, GPP alleged unspecified monetary damages for the period from February 25, 2003 to June 16, 2003 and sought to prevent Oasis Pipe Line from implementing flow control measures to reduce the flow of gas to their power plant at varying hourly rates. Oasis Pipe Line filed a counterclaim against GPP asking for damages and a declaration that the contract was terminated as a result of the breach by GPP. Oasis Pipe Line and GPP agreed to a stand still order and referred this dispute to binding arbitration. Oasis Pipe Line has retained trial counsel to defend this matter and is proceeding with the preparation of its case in the arbitration.

The Partnership is involved in various lawsuits, claims, and/or regulatory proceedings incidental to its business. In the opinion of management, the outcome of such matters will not have a material adverse effect on the Partnership's financial position or results of operations.

***Environmental***

The Partnership's operations are subject to extensive federal, state and local environmental laws and regulations that require expenditures for remediation at operating facilities and waste disposal sites. Although the Partnership believes its operations are in substantial compliance with applicable environmental laws and regulations, risks of additional costs and liabilities are inherent in the natural gas pipeline and processing business, and there can be no assurance that significant costs and liabilities will not be incurred. Moreover, it is possible that other developments, such as increasingly stringent environmental laws, regulations and enforcement policies thereunder, and claims for damages to property or persons resulting from the operations, could result in substantial costs and liabilities. Accordingly, the Partnership has adopted policies, practices, and procedures in the areas of pollution control, product safety, occupational health, and the handling, storage, use, and disposal of hazardous materials to prevent material environmental or other damage, and to limit the financial liability, which could result from such events. However, some risk of environmental or other damage is inherent in the natural gas pipeline and processing business, as it is with other entities engaged in similar businesses.

In conjunction with the acquisition of the Texas and Oklahoma natural gas gathering and gas processing assets from Aquila Gas Pipeline, Aquila, Inc. agreed to indemnify Energy Transfer for any environmental liabilities that arose from operations of the assets purchased prior to October 1, 2002. Aquila also agreed to indemnify the Partnership for 50% of any environmental liabilities that arose from operations of the Oasis Pipe Line assets purchased prior to October 1, 2002.

Environmental exposures and liabilities are difficult to assess and estimate due to unknown factors such as the magnitude of possible contamination, the timing and extent of remediation, the determination of the Partnership's liability in proportion to other parties, improvements in cleanup technologies and the extent to which environmental laws and regulations may change in the future. Although environmental costs may have a significant impact on the results of operations for any single period, the Partnership believes that such costs will not have a material adverse effect on its financial position. As of August 31, 2003, the Partnership has \$633,000 accrued to cover any material environmental liabilities that were not covered by the environmental indemnifications.



**Table of Contents****Index to Financial Statements****12. Price Risk Management Assets and Liabilities*****Commodity Price Risk***

The Partnership is exposed to market risks related to the volatility of natural gas and NGL prices. To reduce the impact of this price volatility, Energy Transfer primarily uses derivative commodity instruments (futures and swaps) to manage its exposures to fluctuations in margins. However, during the 11 months ended August 31, 2003, management has generally elected not to designate its commodity derivatives as hedges for accounting purposes.

The following summarizes Energy Transfer's commodity derivative positions at August 31, 2003:

| <b>Basis Swaps</b> | <b>Commodity</b> | <b>Notional Volume<br/>MMBTU</b> | <b>Maturity</b> | <b>Energy Transfer<br/>Pays</b> | <b>Energy Transfer<br/>Receives</b> | <b>Fair Value</b> |
|--------------------|------------------|----------------------------------|-----------------|---------------------------------|-------------------------------------|-------------------|
| HSC                | Gas              | 6,865,000                        | 2003            | Nymex                           | IFERC                               | \$ (250,650)      |
|                    | Gas              | 14,870,000                       | 2003            | IFERC                           | Nymex                               | 1,000,713         |
| HSC                | Gas              | 900,000                          | 2004            | Nymex                           | IFERC                               | 2,250             |
|                    | Gas              | 450,000                          | 2004            | IFERC                           | Nymex                               | (1,125)           |
| Waha               | Gas              | 2,400,000                        | 2003            | Nymex                           | IFERC                               | 64,200            |
|                    | Gas              | 7,230,000                        | 2003            | IFERC                           | Nymex                               | (325,525)         |
| Waha               | Gas              |                                  | 2004            | Nymex                           | IFERC                               |                   |
|                    | Gas              | 1,780,000                        | 2004            | IFERC                           | Nymex                               | (62,300)          |
|                    |                  |                                  |                 |                                 |                                     | <b>\$ 427,563</b> |

| <b>Futures</b> | <b>Commodity</b> | <b>Long/Short</b> | <b>Notional Volume<br/>MMBTU</b> | <b>Maturity</b> | <b>Average Strike<br/>Price</b> | <b>Fair Value</b> |
|----------------|------------------|-------------------|----------------------------------|-----------------|---------------------------------|-------------------|
|                | Gas              | Long              | 3,085,000                        | 2003            | \$ 4.979                        | \$ (52,970)       |
|                | Gas              | Short             | 5,910,000                        | 2003            | \$ 5.039                        | 533,865           |
|                | Gas              | Short             | 60,000                           | 2004            | \$ 5.285                        | 7,480             |
|                | Gas              | Long              | 30,000                           | 2004            | \$ 5.257                        | (2,890)           |
|                |                  |                   |                                  |                 |                                 | <b>\$ 485,485</b> |

**Table of Contents**

**Index to Financial Statements**

***Interest Rate Risk***

Energy Transfer is exposed to market risk for changes in interest rates related to its term note. An interest rate swap agreement is used to manage a portion of the exposure to changing interest rates by converting floating rate debt to fixed-rate debt. On October 9, 2002, Energy Transfer entered into an interest rate swap agreement to manage its exposure to changes in interest rates. The interest rate swap has a notional value of \$75 million and is tied to the maturity of the term note. Under the terms of the interest rate swap agreement, Energy Transfer pays a fixed rate of 2.76% and receives three-month LIBOR with quarterly settlement commencing on January 9, 2003. Management has elected not to designate the swap as a hedge for accounting purposes. The fair value of the interest rate swap at August 31, 2003 is a liability of \$807,000 and has been recognized as a component of interest.

Unrealized gains recognized in earnings related to Energy Transfer's commodity derivative activities were \$912,000 for the 11 months ended August 31, 2003. The realized losses on commodity derivatives, which were included in revenue, for the 11 months ended August 31, 2003, were \$2,001,000. Realized losses on the interest rate swap included in interest expense were \$312,000.

Management believes that many of its derivatives positions would qualify as hedges if management had designated them as such for accounting purposes. Had Energy Transfer designated its derivatives as hedges for accounting purposes, a substantial portion of the fair value of its derivatives at August 31, 2003 would not have been recognized through earnings.

**13. Segment Disclosures**

Prior to December 27, 2002, Energy Transfer operated in only one segment, the Midstream segment, consisting of the natural gas gathering, processing and transportation operations. Effective January 1, 2003, upon completion of the Oasis Pipe Line stock redemption, the Partnership operates in two segments, the Midstream segment and the Transportation segment, consisting of Oasis Pipe Line.

The Midstream segment, which focuses on the gathering, compression, treating, processing, transportation and marketing of natural gas, primarily at our Southeast Texas System and our Elk City Systems, generates revenue primarily by the volumes of natural gas gathered, compressed, treated, processed, transported, purchased and sold through our pipeline (excluding Oasis Pipe Line) and gathering systems and the level of natural gas and NGL prices. In 2003, the Partnership's equity method investments are included in the Midstream segment. In addition, the Partnership's two largest customers' revenues are included in the Midstream segment's revenues.

The Transportation Segment, which focuses on the transportation of natural gas through our Oasis Pipe Line, generates revenue from the fees charged to customers to transport gas through or reserve capacity on our pipeline.

For the 11 months ended August 31, 2003:

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|                               | Intersegment   |                |              | Total        |
|-------------------------------|----------------|----------------|--------------|--------------|
|                               | Midstream      | Transportation | Eliminations |              |
|                               | (In thousands) |                |              |              |
| Revenue                       | \$ 988,587     | \$ 30,617      | \$ (10,481)  | \$ 1,008,723 |
| Cost of sales                 | \$ 909,901     | \$ 119         | \$ (10,481)  | \$ 899,539   |
| Depreciation and amortization | \$ 10,647      | \$ 2,814       |              | \$ 13,461    |
| Income from operations        | \$ 43,900      | \$ 17,689      |              | \$ 61,589    |
| Interest, expense, net        | \$ 11,526      | \$ 5,096       | \$ (4,565)   | \$ 12,057    |
| Income tax                    | \$             | \$ 4,432       |              | \$ 4,432     |
| Net Income                    | \$ 38,419      | \$ 8,206       |              | \$ 46,625    |
| Capital expenditures          | \$ 13,306      | \$ 566         |              | \$ 13,872    |
| Total assets                  | \$ 414,552     | \$ 189,007     | \$ (2,866)   | \$ 600,693   |

F-35



**Table of Contents**

**Index to Financial Statements**

**14. Subsequent Event**

On November 6, 2003, we publicly announced the signing of definitive agreements to combine our operations with those of Heritage Propane Partners, L.P. ( Heritage ), which is engaged in the retail propane business. The transaction will create a combined entity with substantially greater scale and scope of operations. We believe our larger size and our entry into the propane business will provide us with substantial internal and external growth opportunities. The value of the consideration payable in this transaction is approximately \$987 million based on the average market price of Heritage common units for the 45 trading days prior to the time we signed these agreements.

Table of Contents

Index to Financial Statements

**REPORT OF INDEPENDENT AUDITORS**

To the Partners of

La Grange Acquisition, LP and Affiliates

We have audited the accompanying consolidated balance sheets of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002 and December 31, 2001, and the related consolidated statements of income, stockholder's equity and cash flows for the period ended September 30, 2002 and the years ended December 31, 2001 and 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Aquila Gas Pipeline Corporation and Subsidiaries as of September 30, 2002 and December 31, 2001, and the results of their operations and their cash flows for the period ended September 30, 2002 and the years ended December 31, 2001 and 2000 in conformity with accounting principles generally accepted in the United States.

As discussed in the Note 1 to the consolidated financial statements, effective January 1, 2002, Aquila Gas Pipeline Corporation and Subsidiaries adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets.

/s/ ERNST & YOUNG LLP

San Antonio, Texas

July 17, 2003

F-37

Table of ContentsIndex to Financial Statements

## AQUILA GAS PIPELINE CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

|   | September 30,     | December 31,      |
|---|-------------------|-------------------|
|   | 2002              | 2001              |
|   | (In thousands)    |                   |
| <b>ASSETS</b>                                     |                   |                   |
| Current assets:                                   |                   |                   |
| Cash and cash equivalents                         | \$                | \$                |
| Accounts receivable                               | 72,154            | 121,093           |
| Inventories and exchanges, net                    |                   | 1,189             |
| Materials and supplies                            | 2,622             | 2,917             |
| Price risk management assets                      | 18,100            | 8,581             |
| Other current assets                              | 66                | 226               |
| Receivable due from affiliated companies          | 23,889            | 10,390            |
|   | <u>116,831</u>    | <u>144,396</u>    |
| Total current assets                              | 116,831           | 144,396           |
| Pipeline, property, plant and equipment, at cost: |                   |                   |
| Natural gas pipelines                             | 465,441           | 468,115           |
| Plants and processing equipment                   | 93,872            | 93,724            |
| Other   | 12,425            | 12,097            |
|   | <u>571,738</u>    | <u>573,936</u>    |
| Less accumulated depreciation                     | (210,399)         | (193,750)         |
|   | <u>361,339</u>    | <u>380,186</u>    |
| Intangible assets, net                            | 5,218             | 8,384             |
| Investment in Oasis Pipe Line                     | 100,748           | 99,322            |
| Other, net  | 475               | 972               |
| Price risk management assets                      | 16,917            |                   |
|   | <u>\$ 601,528</u> | <u>\$ 633,260</u> |
| Total assets                                      | \$ 601,528        | \$ 633,260        |
| <b>LIABILITIES AND STOCKHOLDER S EQUITY</b>       |                   |                   |
| Current liabilities:                              |                   |                   |
| Accounts payable                                  | \$ 71,981         | \$ 131,118        |
| Accrued expenses                                  | 3,938             | 8,469             |
| Current maturities of long-term debt              |                   | 12,500            |
| Accrued interest                                  | 975               | 269               |
| Exchanges payable                                 | 784               |                   |
| Price risk management liabilities                 | 19,334            | 955               |
| Payable to affiliated companies                   | 47,064            | 41,505            |
|   | <u>144,076</u>    | <u>194,816</u>    |
| Total current liabilities                         | 144,076           | 194,816           |

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|  |                   |                   |
|--|-------------------|-------------------|
| Long-term debt   | 66,250            | 66,250            |
| Deferred income taxes  | 121,718           | 122,674           |
| Price risk management liabilities  | 15,225            |                   |
| Commitments and contingencies  |                   |                   |
| Stockholder's equity:  |                   |                   |
| Common stock, \$1.00 par value, 1,000 shares authorized and 10 shares issued |                   |                   |
| Additional paid-in capital   | 90,591            | 90,591            |
| Retained earnings  | 163,668           | 158,929           |
|  | <u>          </u> | <u>          </u> |
| Total stockholder's equity   | 254,259           | 249,520           |
|  | <u>          </u> | <u>          </u> |
| Total liabilities and stockholder's equity                                   | \$ 601,528        | \$ 633,260        |
|  | <u>          </u> | <u>          </u> |

See accompanying notes.

F-38

Table of ContentsIndex to Financial Statements

## AQUILA GAS PIPELINE CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

|   | Nine Months<br>Ended<br>September 30, | Year Ended December 31, |              |
|---|---------------------------------------|-------------------------|--------------|
|   | 2002                                  | 2001                    | 2000         |
|   |                                       | (In thousands)          |              |
| Operating revenues                      | \$ 933,099                            | \$ 1,813,850            | \$ 1,758,530 |
| Costs and expenses:                     |                                       |                         |              |
| Cost of sales                           | 880,064                               | 1,715,261               | 1,640,867    |
| Operating                               | 12,717                                | 18,126                  | 19,983       |
| General and administrative              | 9,575                                 | 19,949                  | 21,290       |
| Depreciation and amortization           | 22,915                                | 30,779                  | 30,049       |
| Asset impairment                        |                                       |                         | 7,800        |
| Unrealized loss (gain) on derivatives   | 4,966                                 | (13,255)                | 7,517        |
| Total costs and expenses                | 930,237                               | 1,770,860               | 1,727,506    |
| Income from operations                  | 2,862                                 | 42,990                  | 31,024       |
| Other income (expense)                  | (84)                                  | 1,901                   | (20)         |
| Equity in net income of Oasis Pipe Line | 5,425                                 | 3,128                   | (14)         |
| Interest and debt expenses, net         | (3,931)                               | (6,858)                 | (12,098)     |
| Income before income taxes              | 4,272                                 | 41,161                  | 18,892       |
| Income tax (benefit) expense            | (467)                                 | 15,403                  | 7,657        |
| Net income                              | \$ 4,739                              | \$ 25,758               | \$ 11,235    |

See accompanying notes.

Table of Contents

Index to Financial Statements

**AQUILA GAS PIPELINE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

**Nine months ended September 30, 2002, and**

**Years ended December 31, 2001 and 2000**

|                             | Common Stock |        | Additional<br>Paid-in | Retained   | Total                  |
|-----------------------------|--------------|--------|-----------------------|------------|------------------------|
|                             | Shares       | Amount | Capital               | Earnings   | Stockholders<br>Equity |
|                             |              |        | (In thousands)        |            |                        |
| Balance, December 31, 1999  |              | \$     | \$ 90,591             | \$ 121,936 | \$ 212,527             |
| Net income                  |              |        |                       | 11,235     | 11,235                 |
| Balance, December 31, 2000  |              |        | 90,591                | 133,171    | 223,762                |
| Net income                  |              |        |                       | 25,758     | 25,758                 |
| Balance, December 31, 2001  |              |        | 90,591                | 158,929    | 249,520                |
| Net income                  |              |        |                       | 4,739      | 4,739                  |
| Balance, September 30, 2002 |              | \$     | \$ 90,591             | \$ 163,668 | \$ 254,259             |

See accompanying notes.



See accompanying notes.

F-41



**Table of Contents**

**Index to Financial Statements**

**AQUILA GAS PIPELINE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Nine Months Ended September 30, 2002,**

**Years Ended December 31, 2001 and 2000**

**(In thousands)**

**1. Summary of Business, Basis of Presentation and Significant Accounting Policies**

***Business***

Aquila Gas Pipeline Corporation (Aquila Gas Pipeline or the Company) and subsidiaries owned and operated natural gas gathering and pipeline systems and gas processing plants and was engaged in the business of purchasing, gathering, transporting, processing and marketing natural gas and natural gas liquids (NGLs) in the States of Texas and Oklahoma.

Effective October 1, 2002, substantially all of the operating assets of Aquila Gas Pipeline were sold for \$264 million to La Grange Acquisition, LP (La Grange Acquisition). La Grange Acquisition did not assume Pipeline's derivative positions or its liabilities, except for certain payables.

***Principles of Consolidation and Basis of Presentation***

Aquila Gas Pipeline was a wholly owned subsidiary of Aquila Merchant Services. Aquila Merchant Services was wholly owned by Aquila, Inc. (Aquila), formerly UtiliCorp United Inc.

The accompanying consolidated financial statements include the accounts of Aquila Gas Pipeline after the elimination of significant intercompany balances and transactions with subsidiaries. Unless otherwise indicated, all amounts included in the notes to the consolidated financial statements are expressed in thousands.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial

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statements and the reported amounts of revenues and expenses during the reporting period. The more significant areas requiring the use of estimates relate to the fair value of financial instruments and useful lives for depreciation. Actual results may differ from those estimates.

The Company was subject to a number of risks inherent in the industry in which it operated, primarily fluctuating prices and gas supply. The Company's financial condition and results of operations depended significantly upon the prices received for natural gas and NGLs. These prices were subject to wide fluctuations due to a variety of factors that were beyond the control of the Company. In addition, the Company had to continually connect new wells to its gathering systems in order to maintain or increase throughput levels to offset natural declines in dedicated volumes. The number of new wells drilled depended on a variety of factors that were beyond the control of the Company.

F-42

**Table of Contents****Index to Financial Statements*****Cash Paid for Interest***

The following provides information related to cash paid for interest. No cash was paid for income taxes as taxes were settled through intercompany accounts with Aquila:

|                                     | September 30,  | December 31, |           |
|-------------------------------------|----------------|--------------|-----------|
|                                     | 2002           | 2001         | 2000      |
|                                     | _____          | _____        | _____     |
|                                     | (In thousands) |              |           |
| Interest, net of amount capitalized | \$ 3,308       | \$ 6,219     | \$ 10,511 |

***Revenue Recognition***

Operating revenues were recognized upon the delivery of natural gas or NGLs to the buyer of the related product or services.

## **Table of Contents**

### **Index to Financial Statements**

#### ***Inventories and Exchanges***

Inventories and exchanges consisted of NGLs on hand or natural gas and NGLs delivery imbalances with others and were presented net by customer/supplier on the consolidated balance sheet. These amounts turned over monthly, and management believed that cost approximated market value. Accordingly, these volumes were valued at market prices on the consolidated balance sheet.

#### ***Materials and Supplies***

Materials and supplies were stated at the lower of cost (determined on a first-in, first-out basis) or market.

#### ***Shipping and Handling Costs***

In accordance with the Emerging Issues Task Force Issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company classified all deductions from producer payments for fuel, compression and treating that can be considered handling costs as revenue. The associated fuel costs were included in cost of sales, while the remaining costs were included in operating costs.

#### ***Commodity Risk Management***

In 1999, Aquila Gas Pipeline transferred all of its energy trading operations and management thereof to Aquila Energy Marketing (AEM), a wholly owned subsidiary of Aquila. AEM entered into forward physical contracts with third parties for the benefit of Aquila Gas Pipeline and where deemed necessary entered into intercompany financial derivative positions (e.g., swaps, futures and options) with Aquila Gas Pipeline and other affiliates to assist them in managing their exposures. Thus, Aquila Gas Pipeline had forward physical contracts with third parties and financial derivative positions with AEM and affiliates. The Company received all gross margins associated with these transactions, and AEM charged Aquila Gas Pipeline for its share of AEM's costs to manage Aquila Gas Pipeline's positions.

The Company accounted for its derivative positions, both speculative forward positions and financial derivatives, under Emerging Issues Task Force Issue 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities* (EITF 98-10). Under EITF 98-10, the Company valued the derivative positions at market value with all changes being recognized in earnings. Realized gains and losses were included in revenues, while unrealized gains and losses were classified as such on the consolidated statements of income. Aquila Gas Pipeline's derivative positions were classified as current or long-term price risk management assets and liabilities based on their maturity.

The market prices used to value these transactions reflected management's estimates considering various factors, including closing exchange and over-the-counter quotations, time value and volatility factors of the underlying commitments. The values were adjusted to reflect the potential impact of liquidating a position in an orderly manner over a reasonable period of time under market conditions.

Although La Grange Acquisition is also involved in energy marketing and uses derivatives to manage its exposures, La Grange Acquisition did not purchase Aquila Gas Pipeline's derivative positions when it purchased its assets. Emerging Issues Task Force Issue 02-03, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management

F-44

## **Table of Contents**

### **Index to Financial Statements**

Activities was issued in the fourth quarter of 2002 and rescinded the provisions of EITF 98-10. As such all energy trading derivative transactions are now governed by Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (Statement No. 133). Under Statement No. 133, La Grange Acquisition will continue to account for its financial derivative positions as mark to market instruments. However, as permitted under Statement No. 133, La Grange Acquisition has adopted a policy of treating all forward physical contracts that require physical delivery as normal purchases and sales contracts. As such, these contracts will not be marked to market and will be accounted for when delivery occurs. Had Aquila Gas Pipeline adopted this policy, it would have reversed unrealized mark to market gains of \$1,938 at September 30, 2002.

### ***Pipeline, Property, Plant and Equipment***

Pipeline, property, plant and equipment were stated at cost. Additions and improvements that added to the productive capacity or extended the useful life of the asset were capitalized. Expenditures for maintenance and repairs that did not add capacity or extended the useful life were charged to expense as incurred. Upon disposition or retirement of pipeline components or gas plant components, any gain or loss was recorded to accumulated depreciation. When entire pipeline systems, gas plants or other property and equipment were retired or sold, any gain or loss was included in operations.

Depreciation of the pipeline systems, gas plants and processing equipment was calculated using the straight-line method based on an estimated useful life of primarily 25 years. Interest cost on funds used to finance major pipeline projects during their construction period was also capitalized. Capitalized interest cost was \$35, \$86 and \$70 for the periods ending September 30, 2002 and December 31, 2001 and 2000, respectively.

The Company reviewed its long-lived assets, including finite lived intangibles, for impairment whenever facts and circumstances indicated impairment was potentially present. When impairment indicators were present, Aquila Gas Pipeline evaluated whether the assets in question were able to generate sufficient cash flows to recover their carrying value on an undiscounted basis. If not, the Company impaired the assets to their fair value, which was determined based on discounted cash flows or estimated salvage value. In 2000, as a result of volume declines at some of Aquila Gas Pipeline's smaller gathering and treating facilities, an impairment charge of \$7.8 million was recognized to reduce the carrying value of these systems to the present value of the future cash flows or salvage value, if greater. The present value of future cash flows was computed assuming a 12% discount rate.

Construction work in progress at September 30, 2002 and December 31, 2001 was \$669 and \$4,484, respectively.

### ***Stock Compensation***

Some of Aquila Gas Pipeline's employees received stock options in Aquila. As permitted under generally accepted accounting principles, Aquila elected to account for the options under Accounting Principles Board Opinion No. 25, and because the options strike price was equal to or greater than the fair value at the date of grant, no compensation expense was recognized. See Note 6, for a summary of the options granted. As these were Aquila options, Aquila Gas Pipeline does not have full access to the information necessary to disclose what compensation expense would have been, had Aquila accounted for the options under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, which requires



## **Table of Contents**

### **Index to Financial Statements**

compensation expense be recognized for the fair value of the options at the date of grant. La Grange Acquisition does not have a stock option plan in place for its employees.

### ***Income Taxes***

Aquila Gas Pipeline was included in the consolidated federal income tax returns filed by Aquila. Accordingly, all tax balances were ultimately settled through Aquila. Aquila Gas Pipeline had generally accounted for its taxes on a stand-alone or separate return basis (see Note 4). Periodically, taxes payable were settled through the intercompany accounts with Aquila and were not funded in cash.

The Company provides for income taxes in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (Statement No. 109). Statement No. 109 requires that deferred tax assets and liabilities be established for the basis differences between the reported amounts of assets and liabilities for financial reporting purposes and income tax purposes.

### ***Equity Method Investments***

Aquila Gas Pipeline had a 50% investment in Oasis Pipe Line Company. Aquila Gas Pipeline accounted for this investment using the equity method.

### ***Adoption of New Accounting Standard***

On January 1, 2002, Aquila Gas Pipeline adopted Statement of Financial Accounting Standards No. 141, *Business Combinations* (Statement No. 141). Statement No. 141 addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. Statement No. 141 was effective for all business combinations initiated after June 30, 2001. Statement No. 141 eliminated the pooling-of-interest method of accounting for business combinations. Statement No. 141 also changed the criteria to recognize intangible assets apart from goodwill. As the Company has historically used the purchase method to account for all business combinations, adoption of this statement did not have a material impact on the Aquila Gas Pipeline's financial position or results of operations.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (Statement No. 142). Statement No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and superseded APB Opinion No. 17, *Intangible Assets*. Statement No. 142 was effective for fiscal years beginning after December 15, 2001. This statement established new accounting for goodwill and other intangible assets recorded in business combinations. Under the new rules, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are be subjected to annual impairment tests in accordance with the statement. Other intangible assets continue to be amortized over their useful lives. Aquila Gas Pipeline adopted this standard on January 1, 2002. As amortization of goodwill was a significant non-cash expense, Statement No. 142 had a material impact on the Company's financial statements. The table below summarizes the financial results as if adoption had occurred on January 1, 2000.



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|   | <u>2001</u>       | <u>2000</u>       |
|---|-------------------|-------------------|
|   | (In thousands)    |                   |
| Reported net income                       | \$ 25,758         | \$ 11,235         |
| Add back: Goodwill amortization           | 900               | 1,147             |
| Add back: Oasis excess basis amortization | 1,650             | 1,650             |
| Taxes                                     | (365)             | (465)             |
|   | <u>          </u> | <u>          </u> |
| Adjusted net income                       | <u>\$ 27,943</u>  | <u>\$ 13,567</u>  |

F-46

**Table of Contents****Index to Financial Statements****2. Related-Party Transactions**

Aquila Gas Pipeline entered into various types of transactions with Aquila and its affiliates. Aquila Gas Pipeline sold natural gas to Aquila and its affiliates and purchased natural gas and NGLs from Aquila. Additionally, Pipeline reimbursed Aquila for the direct and indirect costs of certain Aquila employees who provided services to the Company and for other costs (primarily general and administrative expenses) related to the Company's operations. Aquila also provided Aquila Gas Pipeline with a revolving credit agreement, as described in Note 3.

In addition, Aquila Gas Pipeline transported gas on Oasis Pipe Line Company's (Oasis Pipe Line) pipeline. In 1999, Aquila Gas Pipeline had a 35 percent investment in the capital stock of Oasis Pipe Line, which was acquired in 1996 and was accounted for using the equity method of accounting. In December 2000, Pipeline's investment in Oasis Pipe Line increased to 50 percent as a result of Oasis Pipe Line's redemption of all the shares of one of its shareholders.

The following table summarizes transactions for the indicated periods:

|   | September 30,  | December 31, |            |
|---|----------------|--------------|------------|
|   | 2002           | 2001         | 2000       |
|   | (In thousands) |              |            |
| Natural gas sales to affiliated companies                   | \$ 166,372     | \$ 325,295   | \$ 249,541 |
| NGLs sales to affiliated companies                          | 373            | 1,267        |            |
| Purchases of natural gas from affiliated companies          | 101,398        | 170,105      | 140,196    |
| Purchases of NGLs from affiliated companies                 | 1,841          |              |            |
| Transportation expense with Oasis                           | 3,900          | 6,727        | 6,835      |
| Recognized (loss) gain from marketing transactions with AEM | 2,678          | (10,605)     | 28,510     |
| Interest expense with Aquila                                | 3,295          | 5,140        | 8,745      |
| Reimbursement of direct costs to Aquila                     | (1,739)        | 15,283       | 7,324      |
| Service agreement expenses charged by Aquila                | 2,628          | 3,504        | 3,504      |

The affiliated receivable due from Aquila was \$23,889 and \$10,390 for the periods ending September 30, 2002 and December 31, 2001, respectively. This receivable was created by overpayments on Aquila Gas Pipeline's revolving credit agreement (see Note 3) with Aquila. The affiliated payable due to Aquila was \$47,064 and \$41,505 as of September 30, 2002 and December 31, 2001, respectively.

**3. Debt**

The following table summarizes Aquila Gas Pipeline's long-term debt:

September 30,      December 31,

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|  | <u>2002</u>      | <u>2001</u>      |
|--|------------------|------------------|
|  | (In thousands)   |                  |
| Loan agreement bearing interest at 6.83%, due 2006 | \$ 16,250        | \$ 16,250        |
| Loan agreement bearing interest at 6.47%, due 2005 | 50,000           | 50,000           |
| 8.29% senior notes, due 2002                       |                  | 12,500           |
|  | <u>66,250</u>    | <u>78,750</u>    |
| Total debt   |                  | (12,500)         |
| Less Current maturities of long-term debt          |                  |                  |
|  | <u>\$ 66,250</u> | <u>\$ 66,250</u> |
| Total long-term debt                               |                  |                  |

F-47

**Table of Contents**

**Index to Financial Statements**

***Revolving Credit Agreement***

Aquila Gas Pipeline had a credit agreement, as amended, with Aquila that provided a revolving credit facility (Revolver) for borrowings of up to \$115,000. As of September 30, 2002, there was \$115,000 available for use under the Revolver. Aquila swept all available cash daily to reduce the revolver. This resulted in a receivable due to Aquila Gas Pipeline of \$23,889 as of September 30, 2002, \$10,390 as of December 31, 2001, and \$38,641 as of June 30, 2002. The Revolver bore interest at Aquila Gas Pipeline's election of either (i) a base rate (the higher of the bank prime rate or 1/2 of 1 percent above the Federal Funds rate), (ii) an adjusted certificate of deposit rate or (iii) a Eurodollar rate. The maturity date of the Revolver automatically renewed in one-year periods from each commitment period (October of any given year), unless Aquila gave at least a one-year notice not to renew. As of September 30, 2002, the maturity date was October 2003. The Revolver was unsecured and was subordinate to the 8.29% senior notes described below. The Company paid an annual commitment fee to Aquila of 1/4 of 1% on the unutilized portion of the revolving credit facility. The Revolver required the Company to comply with certain restrictive covenants. At September 30, 2002, Aquila Gas Pipeline was in compliance with such covenants.

***Loan Agreements***

In 1995, Aquila Gas Pipeline entered into a loan agreement with Aquila Energy, a subsidiary of Aquila for \$50,000. The loan was unsecured and bore interest at 6.47% due semi-annually. The principal amount of the loan was to be repaid to Aquila Energy by June 1, 2005. In 1997, Aquila Gas Pipeline entered into a second loan agreement with Aquila Energy for \$16,250. This loan was unsecured and bore interest at 6.83% due semi-annually. The principal amount of the second loan was to be repaid to Aquila Energy by October 15, 2006.

***Senior Notes***

The 8.29% Senior Notes (Senior Notes) were unsecured and interest payments were due semi-annually. Principal payments of \$12,500 were required each year and the balance was paid in full in September 2002. Upon issuance of the Senior Notes, Aquila Gas Pipeline deferred approximately \$1,886 of initial fees and expenses that were amortized over the life of the notes.

**4. Income Taxes**

Components of income tax provision/(benefit) attributable to income before taxes are as follows:

|         | September 30,  | December 31, |           |
|---------|----------------|--------------|-----------|
|         | 2002           | 2001         | 2000      |
|         | (In thousands) |              |           |
| Current | \$ 489         | \$ 5,560     | \$ 11,343 |

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|          |                 |                  |                 |
|----------|-----------------|------------------|-----------------|
| Deferred | <u>(956)</u>    | <u>9,843</u>     | <u>(3,686)</u>  |
| Total    | <u>\$ (467)</u> | <u>\$ 15,403</u> | <u>\$ 7,657</u> |

F-48

**Table of Contents****Index to Financial Statements**

Tax expense was different than the amount computed by applying the statutory federal income tax rate to income before taxes. A reconciliation of Aquila Gas Pipeline's income taxes with the United States Federal statutory rate is as follows:

|  | September 30,  | December 31, |       |
|--|----------------|--------------|-------|
|  | 2002           | 2001         | 2000  |
|  | (In thousands) |              |       |
| Book income at U.S. federal statutory rate | 35.0%          | 35.0%        | 35.0% |
| Equity method earnings                     | (51.4)         | (3.3)        |       |
| State taxes                                | 3.5            | 3.5          | 3.5   |
| Other                                      | 2.0            | 2.0          | 2.0   |
| Tax provision effective rate               | (10.9)%        | (37.2)%      | 40.5% |

Deferred taxes resulted from the effect of transactions that were recognized in different periods for financial and tax reporting purposes. Significant components of the Company's deferred tax assets and liabilities were as follows:

|                                       | September 30,  | December 31, |
|---------------------------------------|----------------|--------------|
|                                       | 2002           | 2001         |
|                                       | (In thousands) |              |
| Deferred tax assets:                  |                |              |
| Basis difference in intangible assets | \$ 6,649       | \$ 6,796     |
| Other                                 | 388            | 2,074        |
| Total deferred tax assets             | 7,037          | 8,870        |
| Deferred tax liabilities:             |                |              |
| Basis difference in fixed assets      | (128,755)      | (131,544)    |
| Net deferred tax liabilities          | \$ (121,718)   | \$ (122,674) |

**5. Major Customers**

The Company's gross sales as a percentage of total revenues to nonaffiliated major customers were as follows:

| September 30, | December 31, |
|---------------|--------------|
|---------------|--------------|

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|            | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|------------|-------------|-------------|-------------|
| Customer A | 17.5%       | 15.4%       | 11.9%       |
| Customer B | 9.6%        | 11.0%       | 8.4%        |

The Company's natural gas operations had a concentration of customers in natural gas transmission, distribution and marketing as well as industrial end-users, while its NGLs operations had a concentration of customers in the refining and petrochemical industries.

These concentrations of customers impacted the Company's overall exposure to credit risk, whether positively or negatively, in that the customers were similarly affected by changes in economic or other

**Table of Contents**

**Index to Financial Statements**

conditions. However, management believed that Aquila Gas Pipeline's portfolio of accounts receivable was sufficiently diversified to minimize any potential credit risk. Historically, Aquila Gas Pipeline has not incurred significant problems in collecting its accounts receivable and, as such, no allowance for doubtful accounts was provided in the accompanying consolidated financial statements. The Company's accounts receivable were generally not collateralized.

**6. Retirement and Benefit Plans**

Aquila had a defined contribution plan for virtually all employees. Pursuant to the plan, employees of the Company could defer a portion of their compensation and contribute it to a deferred account. The Company's matching contributions to the plan were \$408, \$444 and \$435 for the periods ended September 30, 2002 and December 31, 2001 and 2000, respectively.

Aquila had a stock contribution plan under which eligible Aquila Gas Pipeline employees received a company contribution of 3 percent of their base income in Aquila common stock. The Company's expense associated with this plan was \$27, \$231 and \$229 for periods ending September 30, 2002 and December 31, 2001 and 2000, respectively. The reduction for 2002 was due to the reduction in the number of employees eligible in 2002 and declines in the market value of the stock.

Aquila had a stock option plan under which eligible Aquila Gas Pipeline employees were granted options to purchase shares of Aquila's common stock. The plan provided that the options would not be granted at a price below the market price at the date of grant. Accordingly, no compensation cost was recognized for the options. The options vested one year from the date of grant and expired 10 years from the date of grant.



**Table of Contents****Index to Financial Statements**

The following table summarizes the options granted to Aquila Gas Pipeline employees:

|                                  | Period Ended  |            |              |            |              |            |
|----------------------------------|---------------|------------|--------------|------------|--------------|------------|
|                                  | September 30, |            | December 31, |            | December 31, |            |
|                                  | 2002          |            | 2001         |            | 2000         |            |
|                                  | Average       |            | Average      |            | Average      |            |
| Options                          | Price         | Options    | Price        | Options    | Price        |            |
| (In thousands)                   |               |            |              |            |              |            |
| Outstanding, beginning of period | 170,298       | \$ 26.8387 | 115,876      | \$ 21.9475 | 108,451      | \$ 22.5366 |
| Granted                          |               |            | 85,810       | 34.8028    | 27,500       | 19.1250    |
| Exercised                        | (825)         | 18.2083    | (25,688)     | 23.4483    | (1,575)      | 28.5700    |
| Forfeited                        | (4,637)       | 22.7246    | (5,700)      | 21.6565    | (18,500)     | 21.2407    |
| Outstanding, end of period       | 164,836       | \$ 26.6896 | 170,298      | \$ 26.8387 | 115,876      | \$ 21.8425 |

**7. Commitments and Contingencies*****Lease Obligations***

The Company had various non-cancelable operating leases. Total lease expense amounted to approximately \$598 for the period ending September 30, 2002, \$1,059 for the period ending December 31, 2001 and \$622 for the period ending December 31, 2000. All leases were transferred to La Grange Acquisition effective October 1, 2002.

The following summarizes the future annual lease payments for the transferred leases for each of the next five years as of September 30, 2002:

|                     | (In thousands) |
|---------------------|----------------|
| 2003                | \$ 775         |
| 2004                | 775            |
| 2005                | 773            |
| 2006                | 64             |
| 2007 and thereafter |                |

***Taxes***

The IRS has examined and proposed adjustments to Aquila's consolidated federal income tax returns for 1988 through 1993. The proposed adjustment affecting the Company was to lengthen the depreciable life of certain pipeline assets owned by Aquila Gas Pipeline. Aquila has filed a petition in U.S. Tax Court contesting the IRS proposed adjustments for the years 1990 through 1991. The IRS has also proposed an adjustment on the same issue for 1992 through 1998. Aquila has tentatively agreed with the IRS to hold this issue in abeyance pending the outcome of the earlier petition.

Aquila intends to vigorously contest the proposed adjustment and believes it is reasonably possible that they will prevail. If resolved unfavorably, it is expected that additional assessments for the years 1999 through September 30, 2002 would be made on the same issue.

Any additional taxes would result in an adjustment to the deferred tax liability with no effect on net income, while any payment of interest or penalties would affect net income. Aquila Gas Pipeline expects that the ultimate resolution of this matter will not have a material adverse effect on its financial position. Under the Asset Purchase Agreement between Aquila and La Grange Acquisition, La Grange Acquisition would not be impacted by resolution of this matter.

**Table of Contents****Index to Financial Statements*****Contingencies***

In 1996, Aquila Gas Pipeline and Exxon entered into a contract, which required Aquila Gas Pipeline to pay Exxon \$5.1 million in 2006 if Aquila Gas Pipeline failed to deliver natural gas containing at least 2 gallons per mcf to the Exxon Katy Plant. In 2000, the determination was made that it was unlikely that the Company would be in a position to supply natural gas that would meet the contract specifications. Included in operating expenses in 2000 was an accrual of \$3.6 million representing the present value of the future settlement. In 2001, the Company reached an agreement with Exxon to cancel the contract for a cash settlement of \$3.7 million and the exchange of property for right-of-way.

The Company was also a party to additional claims and was involved in various other litigation and administrative proceedings arising in the normal course of business. Aquila Gas Pipeline believed it was unlikely that the final outcome of any of the claims, litigation or proceedings to which it was a party would have a material adverse effect on its financial position or results of operations. However, due to the inherent uncertainty of litigation, there can be no assurance that the resolution of any particular claim or proceeding would not have an adverse effect on the Company's results of operations for the fiscal period in which such resolution occurred. Per the Asset Purchase Agreement between Aquila and La Grange Acquisition, Aquila has agreed to indemnify La Grange Acquisition for any litigation arising from operations before October 1, 2002.

In the normal course of business of its natural gas pipeline operations, the Company purchased, processed and sold natural gas pursuant to long-term contracts. Such contracts contained terms, which were customary in the industry. The Company believes that such terms were commercially reasonable and will not have a material adverse effect on its financial position or results of operations.

**8. Commodity Risk Management**

The following table details information on the Company's positions held or issued for trading purposes as of:

**September 30, 2002**

|                    | Commodity | Notional   |          | Aquila Pays | Aquila Receives | Fair Value |
|--------------------|-----------|------------|----------|-------------|-----------------|------------|
|                    |           | Volume Bcf | Maturity |             |                 |            |
| <b>Basis Swaps</b> |           |            |          |             |                 |            |
| EPNG Permian       | Gas       | 0.4        | 2002     | Nymex       | IFERC           | \$ (142)   |
| EPNG Permian       | Gas       | 0.4        | 2002     | IFERC       | Nymex           | 143        |
| Waha               | Gas       | 3.3        | 2005     | Nymex       | IFERC           | (711)      |
| Waha               | Gas       | 4.1        | 2005     | IFERC       | Nymex           | 826        |
| Houston Ship       | Gas       | 0.6        | 2005     | Nymex       | IFERC           | (40)       |
| Houston Ship       | Gas       | 0.6        | 2005     | IFERC       | Nymex           | 44         |

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|               |     |       |      |       |       |         |
|---------------|-----|-------|------|-------|-------|---------|
| EPNG Permian  | Gas | 1.5   | 2003 | Nymex | IFERC | (723)   |
| EPNG Permian  | Gas | 1.5   | 2003 | IFERC | Nymex | 731     |
| EPNG San Juan | Gas |       | 2002 | Nymex | IFERC | (456)   |
| EPNG San Juan | Gas |       | 2002 | IFERC | Nymex | 714     |
| Houston Ship  | Gas | 101.3 | 2005 | Nymex | IFERC | (1,038) |
| Houston Ship  | Gas | 96.7  | 2005 | IFERC | Nymex | 1,076   |
| Katy          | Gas |       | 2002 | Nymex | IFERC | (89)    |
| Katy          | Gas |       | 2002 | IFERC | Nymex | 94      |
| TGP TX        | Gas |       | 2002 | Nymex | IFERC | (36)    |
| TGP TX        | Gas |       | 2002 | IFERC | Nymex | 16      |
| SOCAL         | Gas | 1.5   | 2003 | Nymex | IFERC | (428)   |
| SOCAL         | Gas | 1.5   | 2003 | IFERC | Nymex | 174     |
| TETCO STX     | Gas | 13.6  | 2005 | Nymex | IFERC | 274     |
| TETCO STX     | Gas | 11.7  | 2005 | IFERC | Nymex | (130)   |
| Waha          | Gas | 97.1  | 2003 | Nymex | IFERC | (8,617) |
| Waha          | Gas | 97.1  | 2003 | IFERC | Nymex | 8,531   |

F-52

**Table of Contents****Index to Financial Statements**

|                     | Buyer/    |           | Notional   |          | Average |          |      |
|---------------------|-----------|-----------|------------|----------|---------|----------|------|
|                     | Seller    |           | Volume     |          | Strike  |          | Fair |
|                     | Commodity | Bcf       | Maturity   | Price    | Value   |          |      |
| <b>Futures</b>      |           |           |            |          |         |          |      |
|                     | Buyer     | Gas       | 0.3        | 2002     | 3.203   | \$ (121) |      |
|                     | Seller    | Gas       | 1.1        | 2002     | 2.685   | (1,086)  |      |
|                     | Buyer     | Gas       | 115.9      | 2005     | 3.733   | 29,518   |      |
|                     | Seller    | Gas       | 114.3      | 2005     | 3.730   | (29,729) |      |
|                     | Buyer     | Gas       | 2.5        | 2002     | 3.150   | 679      |      |
|                     | Seller    | Gas       | 3.4        | 2002     | 2.995   | (810)    |      |
| <b>Forwards</b>     |           |           |            |          |         |          |      |
|                     | Buyer     | Gas       | 181.0      | 2020     | 2.919   | (3,683)  |      |
|                     | Seller    | Gas       | 339.7      | 2020     | 3.686   | 6,570    |      |
|                     | Buyer     | Transport | 15.3       | 2004     | 0.029   | (12)     |      |
|                     |           |           |            |          | Average |          |      |
|                     | Buyer/    |           | Barrels in |          | Strike  |          | Fair |
|                     | Seller    | Commodity | Thousands  | Maturity | Price   | Value    |      |
| <b>NGLs Futures</b> |           |           |            |          |         |          |      |
|                     | Seller    | Ethane    | 150        | 2002     | 0.215   | \$ 194   |      |
|                     | Buyer     | Ethane    | 150        | 2002     | 0.265   | 121      |      |
|                     | Seller    | Propane   | 75         | 2002     | 0.373   | 265      |      |
|                     | Buyer     | Propane   | 135        | 2002     | 0.406   | (287)    |      |
|                     | Seller    | Crude     | (254)      | 2002     | 29.552  | (1,374)  |      |

**December 31, 2001**

|                    | Commodity | Notional |          | Aquila |          | Fair       |
|--------------------|-----------|----------|----------|--------|----------|------------|
|                    |           | Volume   |          | Aquila |          | Fair       |
|                    |           | Bcf      | Maturity | Pays   | Receives | Value      |
| <b>Basis Swaps</b> |           |          |          |        |          |            |
| EPNG Permian       | Gas       | 12.4     | 2005     | Nymex  | IFERC    | \$ (2,597) |
| EPNG Permian       | Gas       | 12.4     | 2005     | IFERC  | Nymex    | 2,635      |
| Waha               | Gas       | 72.8     | 2005     | Nymex  | IFERC    | (1,463)    |
| Waha               | Gas       | 79.5     | 2005     | IFERC  | Nymex    | 2,373      |
| Houston Ship       | Gas       | 27.1     | 2005     | Nymex  | IFERC    | 779        |
| Houston Ship       | Gas       | 28.1     | 2005     | IFERC  | Nymex    | (1,177)    |
| EPNG Permian       | Gas       | 52.8     | 2002     | Nymex  | IFERC    | (4,201)    |
| EPNG Permian       | Gas       | 52       | 2002     | IFERC  | Nymex    | 4,267      |
| EPNG San Juan      | Gas       | 3.1      | 2002     | Nymex  | IFERC    | (96)       |
| EPNG San Juan      | Gas       | 3.1      | 2002     | IFERC  | Nymex    | 134        |
| Henry Hub          | Gas       | 4        | 2002     | Nymex  | IFERC    | (185)      |

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|              |     |       |      |       |       |         |
|--------------|-----|-------|------|-------|-------|---------|
| Henry Hub    | Gas | 3.4   | 2002 | IFERC | Nymex | 133     |
| Houston Ship | Gas | 264.1 | 2005 | Nymex | IFERC | 7,959   |
| Houston Ship | Gas | 261.4 | 2005 | IFERC | Nymex | (7,424) |
| Houston Ship | Gas | 0.90  | 2002 | Nymex | IFERC | (21)    |
| Houston Ship | Gas | 0.90  | 2002 | IFERC | Nymex | (41)    |
| PEPL         | Gas | 2.7   | 2002 | Nymex | IFERC | 48      |
| PEPL         | Gas | 2.7   | 2002 | IFERC | Nymex | (46)    |
| PEPL         | Gas | 2.7   | 2002 | Nymex | IFERC | 45      |
| SOCAL        | Gas | 2.3   | 2002 | Nymex | IFERC | (976)   |
| SOCAL        | Gas | 2.3   | 2002 | IFERC | Nymex | 711     |
| TETCO STX    | Gas | 21.2  | 2005 | Nymex | IFERC | 270     |
| TETCO STX    | Gas | 10.6  | 2005 | IFERC | Nymex | (281)   |
| Waha         | Gas | 312.3 | 2003 | Nymex | IFERC | (3,278) |
| Waha         | Gas | 315.6 | 2003 | IFERC | Nymex | 3,503   |

|                 | Buyer/<br>Seller | Commodity | Notional |          | Average         |               |
|-----------------|------------------|-----------|----------|----------|-----------------|---------------|
|                 |                  |           | Volume   |          | Strike<br>Price | Fair<br>Value |
|                 |                  |           | Bcf      | Maturity |                 |               |
| <b>Futures</b>  |                  |           |          |          |                 |               |
|                 | Buyer            | Gas       | 8.1      | 2005     | 2.806           | \$ (2,318)    |
|                 | Seller           | Gas       | 13.6     | 2005     | 2.902           | 5,015         |
|                 | Buyer            | Gas       | 246.1    | 2005     | 3.807           | (37,627)      |
|                 | Seller           | Gas       | 269.1    | 2005     | 3.761           | 37,682        |
|                 | Buyer            | Gas       | 3.6      | 2002     | 2.777           | (1,156)       |
|                 | Seller           | Gas       | 11       | 2002     | 2.780           | 1,757         |
| <b>Forwards</b> |                  |           |          |          |                 |               |
|                 | Buyer            | Gas       | 97.9     | 2020     | 2.826           | (2,709)       |
|                 | Seller           | Gas       | 424.3    | 2020     | 2.688           | 3,673         |
|                 | Buyer            | Transport | 23.3     | 2004     | 0.016           | (18)          |

F-53

**Table of Contents****Index to Financial Statements**

|             |                  |           |                         |          | Average         |               |
|-------------|------------------|-----------|-------------------------|----------|-----------------|---------------|
|             | Buyer/<br>Seller | Commodity | Barrels in<br>Thousands | Maturity | Strike<br>Price | Fair<br>Value |
| <b>NGLs</b> |                  |           |                         |          |                 |               |
| Futures     | Buyer            | Ethane    | 600                     | 2002     | 0.215           | \$(1,417)     |
|             | Seller           | Ethane    | 600                     | 2002     | 0.265           | 1,260         |
|             | Buyer            | Propane   | 180                     | 2002     | 0.310           | 213           |
|             | Seller           | Propane   | 240                     | 2002     | 0.408           | 699           |
|             | Seller           | Propane   | 180                     | 2002     | 0.310           | (225)         |
|             | Buyer            | Crude     | (702)                   | 2002     | 20.344          | 904           |
| Forwards    | Seller           | Ethane    | 300                     | 2002     | 0.405           | 822           |

The net gain from derivative activities for the periods ended September 30, 2002, December 31, 2001 and 2000 was \$6,273, \$9,016 and \$1,409, respectively.

**Table of Contents**

**Index to Financial Statements**

**9. Financial Instruments**

The Company's carrying amounts for cash and cash equivalents, accounts receivable, other current assets, accounts payable and other current liabilities approximated fair value. The fair values of its derivative positions are disclosed in Note 8. The following summarizes the Company's carrying value and estimated fair value of its long-term debt obligations:

|            | <u>September 30, 2002</u> |                   | <u>December 31, 2001</u> |                   |
|------------|---------------------------|-------------------|--------------------------|-------------------|
|            | <u>Carrying Value</u>     | <u>Fair Value</u> | <u>Carrying Value</u>    | <u>Fair Value</u> |
|            | (In thousands)            |                   |                          |                   |
| 6.83% Loan | \$ 16,250                 | \$ 19,123         | \$ 16,250                | \$ 19,639         |
| 6.47% Loan | 50,000                    | 55,751            | 50,000                   | 57,335            |
| Total      | <u>\$ 66,250</u>          | <u>\$ 74,874</u>  | <u>\$ 66,250</u>         | <u>\$ 76,974</u>  |

**10. Intangible Assets**

The following table details the items included in intangible assets:

|                                      | <u>Period Ended</u>  | <u>Year Ended</u>   |
|--------------------------------------|----------------------|---------------------|
|                                      | <u>September 30,</u> | <u>December 31,</u> |
|                                      | <u>2002</u>          | <u>2001</u>         |
|                                      | (In thousands)       |                     |
| Goodwill                             | \$ 9,491             | \$ 9,491            |
| Less: amortization                   | (7,837)              | (7,837)             |
|                                      | <u>1,654</u>         | <u>1,654</u>        |
| Oasis transportation rights          | 18,620               | 18,620              |
| Less: amortization                   | (15,905)             | (13,475)            |
|                                      | <u>2,715</u>         | <u>5,145</u>        |
| Gathering producer relationship      | 14,930               | 14,930              |
| Less: amortization                   | (14,081)             | (13,355)            |
|                                      | <u>849</u>           | <u>1,575</u>        |
| Senior note deferred financing costs |                      | 1,886               |
| Less: amortization                   |                      | (1,876)             |



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|                  |          |          |
|------------------|----------|----------|
|                  |          | 10       |
| Intangibles, net | \$ 5,218 | \$ 8,384 |

Effective January 1, 2002, in accordance with Statements of Financial Accounting Standards No. 141 and No. 142, the Company ceased amortizing its goodwill. Further, the Company concluded that the carrying value of the goodwill was not impaired. Goodwill amortization was \$900 and \$1,147 in 2001 and 2000, respectively. Amortization expense, excluding goodwill amortization, was \$3,644, \$5,031 and \$5,072 in September 30, 2002 and December 31, 2001 and 2000, respectively.

At September 30, 2002, the estimated five-year amortization of the Oasis Pipe Line transportation rights and gathering producer relationships was as follows:

|                   | (In thousands)  |
|-------------------|-----------------|
| Remainder of 2002 | \$ 840          |
| 2003              | 1,990           |
| 2004              | 91              |
| 2005              | 91              |
| 2006              | 91              |
| 2007              | 91              |
| Thereafter        | 370             |
|                   | <u>\$ 3,564</u> |

**Table of Contents****Index to Financial Statements**

The Oasis Pipe Line transportation rights was an agreement between Aquila Gas Pipeline and Oasis Pipe Line whereby Aquila Gas Pipeline could elect to reserve a portion of Oasis Pipe Line's line capacity in advance. The agreement has been amended numerous times, and under the most recent amendment it was cancelable by either party upon ninety days notice and it was scheduled to expire in July 2003. The gathering producer relationships related to certain fixed price gathering contracts that were being amortized over ten years.

**11. Investment in Subsidiaries*****Oasis Pipe Line***

Prior to December 2000, Aquila Gas Pipeline had a 35% interest in Oasis Pipe Line. Thereafter, Aquila Gas Pipeline held 50% of the stock of Oasis Pipe Line. The following table presents financial information related to Oasis Pipe Line for the periods presented:

|                                   | <b>Period Ended</b>   |                     |                     |
|-----------------------------------|-----------------------|---------------------|---------------------|
|                                   | <b>September 30,</b>  | <b>December 31,</b> | <b>December 31,</b> |
|                                   | <b>2002</b>           | <b>2001</b>         | <b>2000</b>         |
|                                   | <b>(In thousands)</b> |                     |                     |
| Revenues                          | \$ 24,733             | \$ 26,153           | \$ 24,729           |
| Total operating expenses          | 7,772                 | 11,266              | 18,152              |
| Income before income tax expense  | 16,700                | 14,707              | 7,191               |
| Net income                        | 10,850                | 9,556               | 4,673               |
| Pipeline's share of net income    | 5,425                 | 4,778               | 1,636               |
| Pipeline's share of distributions | 4,000                 | 1,500               |                     |
| Current assets                    | 10,680                | 7,061               | 9,388               |
| Total assets                      | 53,929                | 50,453              | 54,732              |
| Current liabilities               | 3,893                 | 1,911               | 14,013              |
| Long-term debt                    |                       |                     |                     |
| Shareholder's equity              | 41,912                | 39,062              | 32,506              |

At September 30, 2002, Aquila Gas Pipeline's investment exceeded its pro-rata share of Oasis Pipe Line's equity by \$79,792. Prior to 2002, the excess purchase price was being amortized \$1,650 per year. In accordance with Aquila Gas Pipeline's adoption of Statement of Financial Accounting Standards No. 141 and 142, this amortization was ceased effective January 1, 2002.

Table of Contents

Index to Financial Statements

**REPORT OF INDEPENDENT AUDITORS**

Oasis Pipe Line Company

We have audited the accompanying consolidated balance sheet of Oasis Pipe Line Company and Subsidiaries as of December 27, 2002, and the related consolidated statement of income, shareholders' equity and cash flow for the period then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Oasis Pipe Line Company and Subsidiaries at December 27, 2002, and the consolidated results of its operations and its cash flows for the period then ended in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

San Antonio, Texas

July 15, 2003

F-57

**Table of Contents**

**Index to Financial Statements**

**INDEPENDENT AUDITORS REPORT**

To Oasis Pipe Line Company:

We have audited the accompanying consolidated balance sheet of Oasis Pipe Line Company and Subsidiaries (the Company) as of December 31, 2001, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the years ended December 31, 2001 and 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2001, and the results of its operations and its cash flows for the years ended December 31, 2001 and 2000, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

Houston, Texas

April 5, 2002

F-58

**Table of Contents****Index to Financial Statements****OASIS PIPE LINE COMPANY AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

|  | December 27,<br>2002 | December 31,<br>2001 |
|--|----------------------|----------------------|
|  | <u>2002</u>          | <u>2001</u>          |
|  | (In thousands)       |                      |
| <b>ASSETS</b>  |                      |                      |
| Current assets:  |                      |                      |
| Cash and cash equivalents  | \$ 7,962             | \$ 2,352             |
| Accounts receivable trade (net of allowance for doubtful accounts of \$153 in 2002 and \$60 in 2001) | 2,290                | 1,997                |
| Accounts receivable affiliates   | 364                  | 552                  |
| Inventories  | 1,215                | 1,351                |
| Refundable income taxes  |                      | 540                  |
| Prepaid insurance  | 325                  | 269                  |
|  | <u>12,156</u>        | <u>7,061</u>         |
| Total current assets   |                      |                      |
| Property, plant, and equipment:  |                      |                      |
| Pipeline facilities  | 169,308              | 168,745              |
| Construction-in-progress   |                      | 119                  |
| Less accumulated depreciation and amortization   | (127,231)            | (125,472)            |
|  | <u>42,077</u>        | <u>43,392</u>        |
| Property, plant, and equipment, net  |                      |                      |
| Other  | 413                  |                      |
|  | <u>42,490</u>        | <u>43,392</u>        |
| Total assets   | <u>\$ 54,646</u>     | <u>\$ 50,453</u>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                      |                      |
| Current liabilities:   |                      |                      |
| Accounts payable trade   | \$ 264               | \$ 230               |
| Accounts payable affiliates  |                      | 13                   |
| Accrued liabilities  | 376                  | 385                  |
| Accrued taxes  | 820                  |                      |
| Accrued taxes, other than income taxes   |                      | 783                  |
| Accrued compensation   | 586                  | 500                  |
|  | <u>2,046</u>         | <u>1,911</u>         |
| Total current liabilities  |                      |                      |
| Deferred income taxes  | 9,461                | 9,480                |
| Commitments and contingencies  |                      |                      |
| Shareholders' equity:  |                      |                      |
| Common stock, \$1 par value; 50,000 shares authorized and 6,667 shares outstanding                   | 7                    | 7                    |
| Additional paid-in capital   | 25,432               | 25,432               |
| Retained earnings  | 35,537               | 31,460               |
|  | <u>60,976</u>        | <u>56,899</u>        |

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|  |           |           |
|--|-----------|-----------|
| Less treasury stock, 2,000 shares          | 17,837    | 17,837    |
| Total shareholders' equity                 | 43,139    | 39,062    |
| Total liabilities and shareholders' equity | \$ 54,646 | \$ 50,453 |

See accompanying notes.

F-59

Table of ContentsIndex to Financial Statements

## OASIS PIPE LINE COMPANY AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

|                                     | Period Ended<br>December<br>27,<br>2002 | Year Ended<br>December 31,<br>2001 | Year Ended<br>December 31,<br>2000 |
|-------------------------------------|---|------------------------------------|------------------------------------|
|                                     | (In thousands)                          |                                    |                                    |
| Operating revenues:                 |   |                                    |                                    |
| Gas transportation third party      | \$ 23,490                               | \$ 15,749                          | \$ 11,628                          |
| Gas transportation affiliates       | 5,975                                   | 8,364                              | 7,953                              |
| Proceeds from pipeline construction |   |                                    | 4,674                              |
| Gas sales third party               | 2,352                                   | 883                                | 94                                 |
| Fuel and unaccounted for gas        |   | 763                                |                                    |
| Other                               | 914                                     | 394                                | 380                                |
| <b>Total operating revenues</b>     | <b>32,731</b>                           | <b>26,153</b>                      | <b>24,729</b>                      |
| Operating expenses:                 |   |                                    |                                    |
| Fuel and unaccounted for gas        | 133                                     |                                    | 3,344                              |
| Operations and maintenance          | 4,469                                   | 4,325                              | 5,045                              |
| Cost of pipeline construction       |   |                                    | 3,887                              |
| Depreciation and amortization       | 2,106                                   | 2,458                              | 2,249                              |
| Taxes, other than income            | 1,207                                   | 1,171                              | 1,300                              |
| Administrative and general          | 2,555                                   | 3,312                              | 2,327                              |
| <b>Total operating expenses</b>     | <b>10,470</b>                           | <b>11,266</b>                      | <b>18,152</b>                      |
| <b>Operating income</b>             | <b>22,261</b>                           | <b>14,887</b>                      | <b>6,577</b>                       |
| Other income (expenses):            |   |                                    |                                    |
| Interest income                     | 64                                      | 193                                | 640                                |
| Interest expense shareholder        |   | (433)                              | (13)                               |
| Other, net                          | (660)                                   | 60                                 | (13)                               |
| <b>Income before income taxes</b>   | <b>21,665</b>                           | <b>14,707</b>                      | <b>7,191</b>                       |
| Income tax expense                  | 7,588                                   | 5,151                              | 2,518                              |
| <b>Net income</b>                   | <b>\$ 14,077</b>                        | <b>\$ 9,556</b>                    | <b>\$ 4,673</b>                    |

See accompanying notes.





Table of ContentsIndex to Financial Statements

## OASIS PIPE LINE COMPANY AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Period Ended December 27, 2002 and Years Ended December 31, 2001 and 2000

|                                   | Common Stock                      |        | Treasury Stock |            | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Total     |
|-----------------------------------|-----------------------------------|--------|----------------|------------|----------------------------------|----------------------|-----------|
|                                   | Shares                            | Amount | Shares         | Amount     |                                  |                      |           |
|                                   | (In thousands, except share data) |        |                |            |                                  |                      |           |
| Balance at January 1, 2000        | 6,667                             | \$ 7   |                | \$         | \$25,432                         | \$ 20,231            | \$ 45,670 |
| Net income                        |                                   |        |                |            |                                  | 4,673                | 4,673     |
| Repurchased common stock          |                                   |        | 2,000          | (17,837)   |                                  |                      | (17,837)  |
| Balance at December 31, 2000      | 6,667                             | 7      | 2,000          | (17,837)   | 25,432                           | 24,904               | 32,506    |
| Net income                        |                                   |        |                |            |                                  | 9,556                | 9,556     |
| Dividends paid (\$.45 per share)  |                                   |        |                |            |                                  | (3,000)              | (3,000)   |
| Balance at December 31, 2001      | 6,667                             | 7      | 2,000          | (17,837)   | 25,432                           | 31,460               | 39,062    |
| Net income                        |                                   |        |                |            |                                  | 14,077               | 14,077    |
| Dividends paid (\$1.50 per share) |                                   |        |                |            |                                  | (10,000)             | (10,000)  |
| Balance at December 27, 2002      | 6,667                             | \$ 7   | 2,000          | \$(17,837) | \$25,432                         | \$ 35,537            | \$ 43,139 |

See accompanying notes.

**Table of Contents****Index to Financial Statements****OASIS PIPE LINE COMPANY AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Period Ended   | Year Ended   | Year Ended   |
|--|----------------|--------------|--------------|
|  | December       | December 31, | December 31, |
|  | 27,            | 2001         | 2000         |
|  | 2002           | 2001         | 2000         |
|  | (In thousands) |              |              |
| <b>Operating Activities</b>  |                |              |              |
| Net income   | \$ 14,077      | \$ 9,556     | \$ 4,673     |
| Reconciliation of net income to net cash provided by operating activities: |                |              |              |
| Depreciation and amortization  | 2,106          | 2,458        | 2,249        |
| Deferred income taxes  | (19)           | 213          | (1,940)      |
| Changes in assets and liabilities that provided (used) cash:               |                |              |              |
| Accounts receivable  | (105)          | (1,744)      | 125          |
| Inventories  | 136            | 120          | 96           |
| Refundable income taxes  | 540            | 488          |              |
| Accounts payable   | 21             | (340)        | 229          |
| Accrued liabilities  | 114            | 96           | (1,945)      |
| Other, net   | (469)          | 3            | (324)        |
| Net cash provided by operating activities                                  | 16,401         | 10,850       | 3,163        |
| <b>Investing Activities</b>  |                |              |              |
| Additions to property, plant, and equipment, net                           | (791)          | (511)        | (1,234)      |
| Sale of property, plant, and equipment                                     |                | 5            | 1,031        |
| Net cash used in investing activities                                      | (791)          | (506)        | (203)        |
| <b>Financing Activities</b>  |                |              |              |
| Repayment of notes payable related parties                                 |                | (11,832)     |              |
| Dividends paid   | (10,000)       | (3,000)      |              |
| Note issued to purchase treasury stock                                     |                |              | 11,832       |
| Purchase of treasury stock   |                |              | (17,832)     |
| Net cash used in financing activities                                      | (10,000)       | (14,832)     | (6,000)      |
| Increase (decrease) in cash and cash equivalents                           | 5,610          | (4,488)      | (3,040)      |
| Cash and cash equivalents, beginning of year                               | 2,352          | 6,840        | 9,880        |
| Cash and cash equivalents, end of year                                     | \$ 7,962       | \$ 2,352     | \$ 6,840     |
| <b>Supplemental cash flow information:</b>                                 |                |              |              |
| Cash paid for income taxes   | \$ 7,080       | \$ 4,450     | \$ 4,431     |

Cash paid for interest

433

13

See accompanying notes.

F-62

**Table of Contents**

**Index to Financial Statements**

**OASIS PIPE LINE COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Period Ended December 27, 2002 and Years Ended December 31, 2001 and 2000**

**1. Control and Ownership of the Company and Related-Party Transactions**

Oasis Pipe Line Company (the Company), a Delaware corporation, is engaged in the operation of an intrastate natural gas transmission system in the state of Texas. Immediately prior to December 27, 2002, the Company was owned 50% by a subsidiary of Aquila Gas Pipeline Corporation (Aquila Gas Pipeline), and 50% by Dow Hydrocarbons & Resources, Inc. (DHRI). Prior to October 4, 2002, Aquila Gas Pipeline was the wholly owned subsidiary of Aquila, Inc. In October 2002, La Grange Acquisition, L.P. (La Grange Acquisition) acquired substantially all the assets of Aquila Gas Pipeline. On December 27, 2002 the Company redeemed all of DHRI's stock using funds advanced from La Grange Acquisition making the Company a wholly owned subsidiary of La Grange Acquisition.

Before December 28, 2000, ownership was 35% by a subsidiary of Aquila Gas Pipeline, 35% by El Paso Field Services (EPFS), and 30% by DHRI. On that date, EPFS sold 5% of its interest to DHRI and the remaining 30% interest was acquired by the Company as treasury stock.

During 2002, 2001 and 2000, the Company derived revenues from its shareholders and their affiliates for the transmission and sale of natural gas. The amount of such net revenues totaled approximately \$5,975,000, \$8,364,000, and \$7,953,000 for the years ended December 27, 2002, and December 31, 2001, and 2000, respectively. Accounts receivable due from affiliates were approximately \$364,000 and \$552,000 for 2002 and 2001, respectively.

During 2000, the Company reacquired 2,000 previously issued shares of capital stock for \$17.8 million. The acquisition was funded with working capital and the borrowing of \$11.8 million from shareholders (Aquila Gas Pipeline and DHRI). The borrowings were represented by notes payable bearing interest at 9%. Interest expense associated with the notes payable was \$433,000 and \$13,000 during 2001 and 2000, respectively. The notes were paid during 2001.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation*

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The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries (collectively, the Company). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated financial statements present the financial position and results of operations of the Company prior to its becoming a subsidiary of La Grange Acquisition and therefore exclude the purchase adjustments relating to the redemption and intercompany promissory note on December 27, 2002 (see Note 7).

### *Inventories*

The Company requires its customers to provide additional gas, based on predetermined quantities of gas to be delivered, for fuel. If the gas is in excess of the Company's needs, the Company can retain the excess gas or sell it to third parties. If additional fuel is required, the Company will purchase additional volumes in the

F-63

**Table of Contents**

**Index to Financial Statements**

market. Inventories represent the gas that is retained. The Company values inventories at the lower of cost or market as of the balance sheet dates.

***Property, Plant, and Equipment***

Normal maintenance that does not add capacity or extend the useful life of the equipment and repairs of property, plant, and equipment are charged to expense as incurred. Improvements that materially extend the useful lives of the assets are capitalized, and the assets replaced, if any, are retired. When capital assets are retired or replaced, the balance of the assets and the accumulated depreciation are removed and any gain or loss upon disposition is included in income. Fixed assets of approximately \$346,000 and \$134,000 were retired during 2002 and 2001, respectively.

Depreciation is computed using the straight-line method of accounting over the estimated useful lives of the related assets. Annual depreciable lives range from 5 to 85 years.

The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets.

***Environmental Expenditures***

Environmental related restoration and remediation costs are recorded as liabilities and expensed when site restoration and environmental remediation and cleanup obligations are either known or considered probable and the related costs can be reasonably estimated.

***Income Taxes***

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial accounting bases and the tax bases of assets and liabilities. The deferred tax effects of these temporary differences are calculated using the tax rates currently in effect.

***Revenue Recognition***

Transportation revenue is recognized as transportation is provided. Capacity payments are recognized when earned in the period capacity was made available.

*Financial Instruments and Credit Risk*

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, and accounts payable. The carrying value of the Company's financial instruments approximates fair value due to their short-term nature. The Company considers all investments with maturities of three months or less at acquisition to be cash equivalents. The Company's receivables are generally from entities involved in the energy industry or significant industrial customers. The Company specifically reviews all its receivables in determining its allowance for doubtful accounts and the receivables are generally unsecured.

F-64

**Table of Contents****Index to Financial Statements***Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from these estimates.

*Reclassifications*

Certain reclassifications have been made to the 2001 and 2000 amounts to conform to the 2002 presentation.

**3. Income Taxes**

Components of income tax provision/(benefit) attributable to income before taxes are as follows:

|                                 | December 27,<br>2002 | December 31,<br>2001 | December 31,<br>2000 |
|---------------------------------|----------------------|----------------------|----------------------|
| Current                         | \$ 7,607             | \$ 4,938             | \$ 4,458             |
| Deferred                        | (19)                 | 213                  | (1,940)              |
| <b>Total income tax expense</b> | <b>\$ 7,588</b>      | <b>\$ 5,151</b>      | <b>\$ 2,518</b>      |

The tax provision effective rate for December 27, 2002 and December 31, 2001 and 2000 was 35%.



**Table of Contents****Index to Financial Statements**

Deferred income taxes consist of the following:

|                               | December 27,<br>2002 | December 31,<br>2001 |
|-------------------------------|----------------------|----------------------|
|                               | <u>          </u>    | <u>          </u>    |
| Property, plant and equipment | \$ (9,178)           | \$ (9,131)           |
| Other                         | (283)                | (349)                |
|                               | <u>          </u>    | <u>          </u>    |
| Net deferred tax liabilities  | \$ (9,461)           | \$ (9,480)           |
|                               | <u>          </u>    | <u>          </u>    |

**4. Employee Benefit Plan**

An employee savings plan is available to all permanent employees, effective the first day of their employment. For every \$1 each employee contributes, the Company matches \$1, not to exceed 5% of each employee's salary subject to the maximum contribution allowed by law. Each employee is fully vested on his or her first day of employment. The Company expensed contributions of approximately \$144,000, \$140,000, and \$140,000 for 2002, 2001 and 2000, respectively.

**5. Contingencies**

The Company is subject to federal, state and local environmental laws and regulations, which generally require expenditures for remediation at operating facilities and waste disposal sites. At December 27, 2002 and December 31, 2001, the Company had reserved approximately \$252,000 and \$292,000 respectively, for the expected costs of complying with such laws and regulations. These expected costs are primarily related to properties previously owned and are recorded on the consolidated balance sheets as accrued liabilities based upon management's estimates of the timing of the expenditure. The purchase and sale agreement between La Grange Acquisition and Aquila Gas Pipeline requires Aquila, Inc. to reimburse Oasis for 50% of any remediation expenditures related to operations prior to October 1, 2002.

On June 16, 2003, Guadalupe Power Partners, L.P. (GPP) sought and obtained a Temporary Restraining Order against Oasis Pipe Line. In their pleadings, GPP alleged unspecified monetary damages for the period from February 25, 2003 to June 16, 2003 and sought to prevent Oasis Pipe Line from implementing flow control measures to reduce the flow of gas to their power plant at varying hourly rates. Oasis Pipe Line filed a counterclaim against GPP asking for damages and a declaration that the contract was terminated as a result of the breach by GPP. Oasis Pipe Line and GPP agreed to a stand still order and referred this dispute to binding arbitration. Oasis Pipe Line has retained trial counsel to defend this matter and a date for the commencement of the arbitration proceedings has not yet been set.

The Company is also party to legal actions that have arisen in the ordinary course of its business. Due to the inherent uncertainty of litigation, the range of any possible loss cannot be estimated with a reasonable degree of precision.

**6. Pipeline Addition**

During 1999, the Company entered into a facility agreement with an affiliate of its customer, American National Power ( ANP ), whereby the Company committed to construct a lateral pipeline connecting the Company's main pipeline to a power plant operated by ANP in exchange for a payment of \$4.7 million, which was received by the Company in 2000. The transaction resulted in a gain of \$787,000 in 2000.

F-66

**Table of Contents**

**Index to Financial Statements**

**7. Stock Redemption**

On December 27, 2002, the Company purchased 50% of its capital stock owned by DHRI for \$87 million. The Company funded the acquisition by borrowing \$87 million from La Grange Acquisition evidenced by a promissory note (the Note ). Effective with the redemption, the Company became a wholly owned subsidiary of La Grange Acquisition and is included in the financial statements of La Grange Acquisition effective December 27, 2002. The Note bears interest at an annual rate of 8.5% with payments of \$1.6 million due monthly until final maturity on February 1, 2006 at which time the remaining balance will be due. The consolidated financial statements present the financial position and results of operations of the Company prior to its becoming a subsidiary of LaGrange Acquisition and therefore exclude the purchase adjustments relating to the redemption and intercompany promissory note on December 27, 2002.

F-67

**Table of Contents**

**Index to Financial Statements**

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(ENERGY TRANSFER LOGO)

1,640,000 Common Units

Representing Limited Partner Interests

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PROSPECTUS SUPPLEMENT

June 17, 2005

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